

China and India in the World Economy and the Implications for Australia

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The emergence of China and India as significant influences in the world economy and in world markets for tradeable goods and services, commodities, labour and financial assets is, arguably, the most significant change in global macro-economics since at least the breakdown of the Bretton Woods currency system in the early 1970s.

From the standpoint of the global economy, it is at least as important as Japan's sustained and rapid growth in the decades following the end of the Second World War, which saw Japan emerge as the world's second largest economy in 1966, a position which it held until 1992.

Over the past decade, China's economy has expanded at an average annual rate of 8.4%, a pace exceeded by only six other countries in the IMF's universe of 180 countries¹; while India's economy has grown at an annual average rate of 6.0%. Over the same period, OECD economies have grown by an annual average of 2.7%.

These growth rates are rapid by historical standards, but are by no means unprecedented for economies at China's and India's stage of economic development.

For example Japan's economy grew at an average annual rate of 8.8% in the 1950s and 10.5% in the 1960s; West Germany grew by 8.2% per annum in the 1950s; South Korea at annual rates of 8.7%, 9.6% and 9.1% in the 1960s, 70s and 80s, respectively; Taiwan at annual rates of 8.5%, 10.0% and 9.2% in the 1950s, 60s and 70s, respectively; and Singapore at annual rates of 9.2%, 9.0%, 7.1% and 7.7% in the decades from the 1950s through the 1990s².

Even in per capita terms, China's and India's impressive growth rates of 6.9% and 4.6% pa, respectively, over the past decade has been exceeded by Japan and West Germany in the 1950s; Japan, Greece, Spain and Taiwan in the 1960s; South Korea, Taiwan and Singapore in the 1970s; and by South Korea in the 1980s.

China is the world's sixth largest economy measured by GDP converted to US dollars at market exchange rates, while India ranks 11th.

Converted to US dollars at purchasing power parities, which as the System of National Accounts emphasizes is the more appropriate measure "when the objective is to

¹ Those being, according to the IMF, Equatorial Guinea, Bosnia and Herzegovina, Azerbaijan, Qatar, Turkmenistan and Burma – those all being small countries whose GDP has been boosted by sharp increases in oil production or whose statistics are of dubious (to say the least) credibility.

² The growth rates in this paragraph and the next are calculated from estimates of real GDP in 1990 US\$ compiled by the Groningen Growth and Development Centre (at the University of Groningen in the Netherlands) and available online at <http://www.ggdc.net/>.

compare the volume of goods and services produced or consumed per head³, China is the second-largest economy in the world, having overtaken France in 1984, Russia in 1985, Germany in 1987 and finally Japan in 1995; while India is the world's 4th largest economy, having passed Italy and France in 1985, Russia in 1992 and Germany in 1997.

If the long-term consensus projections compiled by Consensus Economics in April this year are vindicated, then as Table 1 indicates, by the year 2015 China will have (just) overtaken the United States as the world's largest economy; while India will have moved past Japan into third place.

Table 1: Actual and projected GDP in US\$ at 2005 PPPs, 2005 and 2015

	<i>GDP - 2005</i>		Projected growth rate, 2005-2015	<i>GDP - 2015(f)</i>	
	<i>US\$ bn</i>	<i>Rank</i>		<i>US\$bn</i>	<i>Rank</i>
United States	12,332	1	3.2	16,950	2
China	8,092	2	8.0	17,533	1
Japan	4,009	3	1.5	4,662	4
India	3,603	4	6.9	7,015	3
Germany	2,499	5	1.5	2,897	5
United Kingdom	1,826	6	2.1	2,250	=7
France	1,812	7	2.1	2,239	9
Italy	1,695	8	1.6	1,978	10
Russia	1,586	9	5.0	2,585	6
Brazil	1,553	10	3.8	2,252	=7
Canada	1,112	11	2.7	1,448	14
Korea	1,099	12	4.5	1,702	11
Mexico	1,065	13	3.7	1,537	=12
Spain	1,026	14	2.8	1,422	15
Indonesia	864	15	6.0	1,543	=12

Sources: IMF (2005); Consensus Economics (2005); author's calculations.

Of course, these projections may prove inaccurate: by and large they extrapolate the growth rates of the recent past, and make no allowance for a global economic downturn, or for downturns in any individual economy, and they do not seem to make much allowance for demographic factors (on which see more below). On the other hand, as noted earlier, the growth rates projected for China and India have been sustained by other countries for long periods.

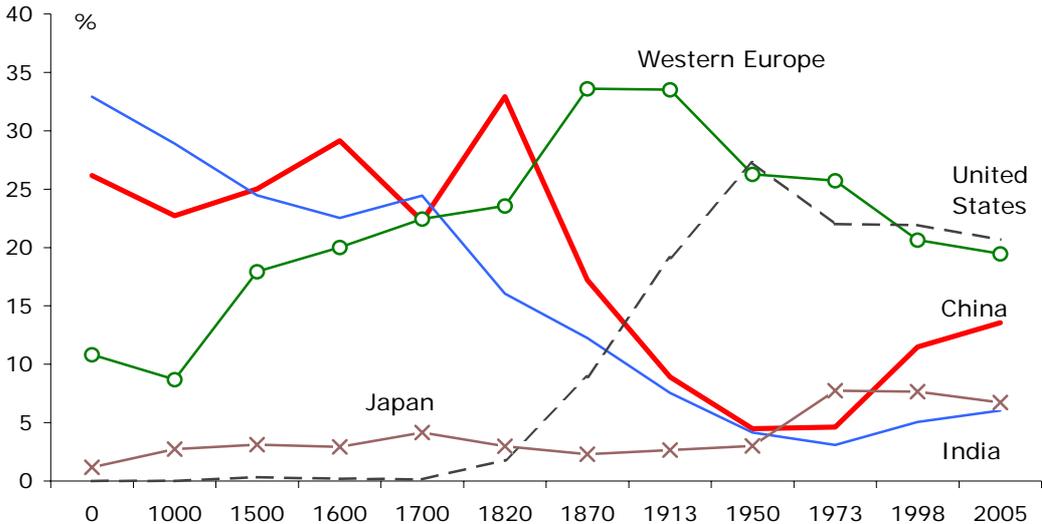
Even though they may rank 1st and 3rd in terms of absolute size in 10-15 years' time, China and India will still be relatively poor countries. On the projections given here, China's per capita GDP will be barely more than one-fifth that of the US (cf. about one-seventh in 2004) and slightly less than one-third of Japan's (cf. a little over one-sixth in 2004); while India's will be about one-tenth that of the US (cf one-thirteenth today) and one-seventh of Japan's (cf one-tenth today).

³ United Nations et al, *System of National Accounts 1993*, paragraph 1.38. See Ian Castles and David Henderson (2005), pp. 55-84, for a discussion of the issues involved in international comparisons of GDP.

From a long-term perspective, the prospect of China and India becoming the world's largest and third-largest economies within the next 10-15 years, represents not an "emergence", something new, as it is usually portrayed, but rather a return to the order which has prevailed throughout most of human history.

According to calculations by Maddison (2001)⁴, from at least the beginning of the common era until the early 19th century, China or India were the world's largest economies.

Chart 1: Major economies' share of global GDP, 0 - 2005



Sources: Maddison (2001); IMF (2005).

This is actually less surprising than it initially sounds when you recall that for much of this period China and India were intact political entities, had the world's largest populations and were technological leaders, while in Western Europe, independent thought and entrepreneurial activity were stifled by superstition and mediaeval Christianity.

As Diamond (1998, 253) notes, "until around AD 1450, China was technologically much more innovative and advanced than Europe". Chinese inventions before or during this period included the wheelbarrow, gunpowder, matches, cast iron, porcelain, magnetic compasses, sternpost rudders, paper, printing, paper money and a meritocratic civil service.

Indian inventions during this period include the decimal system and the concept of zero, the water-wheel, cotton-ginning, cloth dyes, brass and the extraction of crystalline sugar from cane⁵.

The decline in the relative importance of China and India between the early 18th and late 20th centuries resulted from, inter alia, the Renaissance, Reformation and then industrial

⁴ For a critique of Maddison's estimates, see Haig (2005).

⁵ Diamond (1998) and Temple (1986).

revolution in Western Europe; the formation and rapid expansion of the United States; China's retreat from engagement with the global economy beginning during the Ming Dynasty and subsequent decay under the Qing; and the impact of colonialism, 'gunboat diplomacy' and 'unequal treaties'.

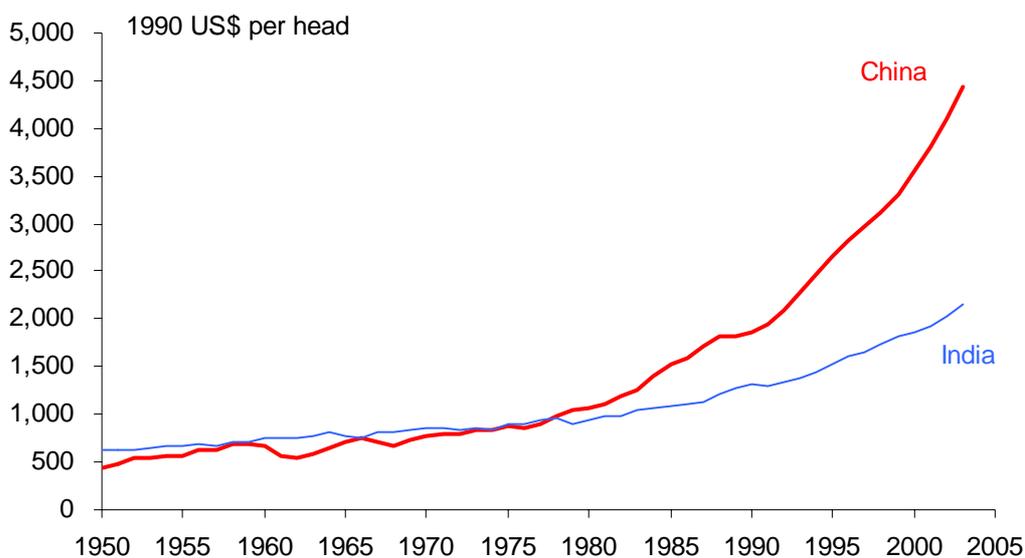
This was followed in the 20th century by nearly fifty years of warfare and social disorder in China followed by another quarter-century of chaos and misrule under Mao Zedong during which an estimated 40 million people died from other than natural causes (a greater number than can be attributed to either Hitler or Stalin).

In India, the attainment of independence from Britain in 1948 was followed by forty years of growth-stultifying socialism, as the Nehru dynasty pursued a utopian ideal of self-sufficiency in everything under the 'licence Raj'.

In both countries, the adoption of more stability-oriented and 'growth-friendly' macro-economic policies, and more importantly the implementation of wide-ranging structural or (as we say in Australia) 'micro-economic reforms' designed to allow a greater role for market forces and the private sector in allocating resources – beginning in China in 1979 and India in 1991 – has allowed them to begin and sustain rapid economic growth. In so doing, China and India have in the last 20 years lifted more people out of poverty than at any other time in human history.

But in most respects China has done significantly better than India. Indeed, in 1950, three years after India gained independence from Britain and the Communists gained complete control of China, India's per capita GDP was some 40% higher than China's. Not until 1978 did China's per capita GDP surpass India's. By 2002, however, China's per capita GDP was more than double India's (see Chart 2).

Chart 2: China and India – per capita GDP 1950-2003



Source: Groningen Growth and Development Centre Total Economy Database, <http://www.ggdc.net/>.

China's superior per capita GDP growth performance than India has stemmed from its greater success in lifting labour force participation, and in sustaining faster rates of productivity growth than India: see Table 2.

China's relatively greater attainments in these areas can be attributed to a wide range of factors, including:

China has saved and invested upwards of 35% of GDP (compared with around 22% in India);

Manufacturing, where productivity gains are typically fastest, has accounted for 50% of China's GDP over the past decade, as against 25% of India's;

China has achieved higher literacy rates (90%, compared with 61% for India), with little difference between men and women, and more favourable health outcomes (life expectancy at birth of 71 in China, compared with 64 for India; infant mortality rate of 29 per 1000 live births in China, compared with 93 in India);

Table 2: Major drivers of Chinese and Indian GDP growth, 1950-2003

Period	<i>Average annual rate of change (%)</i>				<i>Per capita GDP</i>	<i>Employment rate (%)[†]</i>
	<i>Population</i>	<i>Change in employment rate</i>	<i>Productivity*</i>	<i>GDP</i>		
<i>China</i>						
1952-60	2.0	1.0	1.8	4.9	2.8	39.5
1961-79	2.0	0.4	2.0	4.4	2.3	42.2
1980-91	1.4	1.5	3.8	6.9	5.3	50.3
1991-03	0.9	0.4	6.7	8.1	7.1	53.0
<i>India</i>						
1952-60	1.9	na	na	4.3	2.3	37.7
1961-79	2.3	-0.3	1.3	3.2	0.9	35.3
1980-91	2.1	0.4	2.8	5.3	3.1	36.9
1991-03	1.8	0.2	4.2	6.2	4.4	37.7

* Defined as GDP per person employed. † Employment as a percent of population. Source: Groningen Growth and Development Centre *Total Economy Database*, <http://www.ggdcc.net/>; and Economics@ANZ computations.

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China is an easier place to do business than India, despite the more widespread use of English and the legal system inherited from Britain – for example according to the World Bank it takes 75 days and costs 55% of per capita income to register a business in China, cf. 126 days and 97% of per capita income in India;

China has been more effective in collecting taxes than India, enabling it to spend more on education and health while running smaller budget deficits (2.6% of GDP over the past decade cf. 5.1% in India);

China has more successfully integrated itself with the global economy – exporting over 26% of its GDP over the last decade cf. India 12½%;

China has made more progress in cutting tariffs. China's weighted mean tariff, by contrast, has declined from 32% in 1992 to just 6% in 2004. India's weighted mean tariff has fallen from 56% in 1990 to 28% in 2004, and less than three-quarters of its tariff lines are 'bound' in accordance with WTO practice.

China has been more successful in attracting foreign direct investment – equivalent to 4% of GDP over the past decade cf. less than 1% of GDP for India, and has been willing to open sectors such as autos and retailing to foreign investment which India to this day has kept closed to foreigners⁶.

China has found it easier to implement 'good economic policy' in part because:

- it has been, and remains, a one-party dictatorship that can in most cases ignore or over-ride public opinion (unlike India);
- because it is except for some outlying areas) essentially a mono-cultural society with a single national language and no strong religious beliefs (unlike India);
- and because it has a long tradition of strong central government (in contrast to the more powerful position of India's States.

However that does not necessarily mean that the hare will outpace the tortoise over the long term:

- China has been much less efficient in its use of capital for investment than India – over the past decade it has taken investment equivalent to 4.2% of GDP to lift China's growth rate by one pc point, compared with 3.7% of GDP in India.
- China has been much less efficient in its use of energy, particularly coal, than India – in 2004 requiring 189mn tons of oil equivalent (mtoe) to produce US\$1mn of GDP (at PPP), an increase of 8½% over the preceding five years, compared with 126 mtoe for India, a decline of 15% over the same period.
- India is much better placed than China to handle the inevitability that once a majority of the population is able to satisfy its basic physical needs and is confident that their children will have good education, good health and good job prospects – which typically occurs when per capita incomes average US\$8-12,000 in today's terms – they start to want to have some say in how they are governed, and by whom.

⁶ Statistics in these paragraph are from the Economist Intelligence Unit database (on-line via Thomson Financial Datastream); UN Development Program (2004); World Bank (2005a and 2005b); and Transparency International (2004).

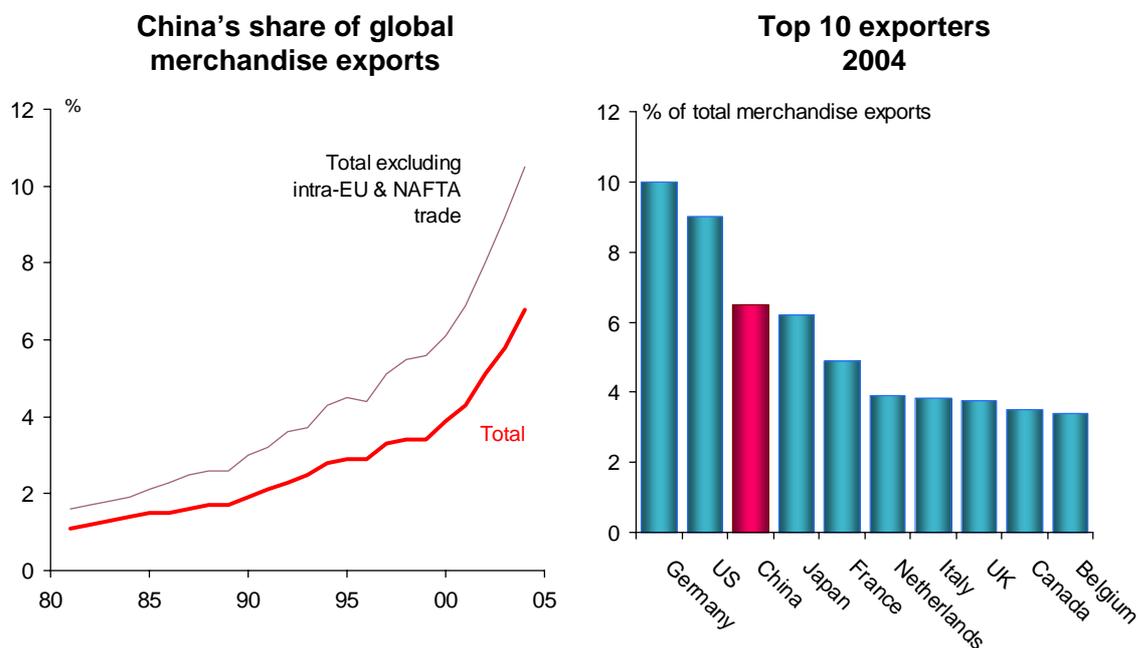
- Finally China confronts a much more serious demographic challenge than India. Largely as a result of the ‘one-child’ policy, China’s population has a median age of 33 compared with 24 in India. 7.6% of China’s population is already aged 65 or over compared with 5.3% in India; in China this will rise to 13.7% by 2025, but to only 8.1% in India. China’s working age (15-65) population will peak at just over 1 bn around 2015, and decline by 15mn over the next ten years, and by a further 141 mn over the following 25 years. India’s working age population will be larger than China’s by 2030, and will still be increasing in 2050 (United Nations (2004), medium variant).

One of the most important ways in which China, and to a lesser extent India, are reshaping the global economy is via its impact on the prices of tradeable goods.

China’s merchandise exports have grown at an average annual rate of 13% per annum since 1981 (in US\$ at market exchange rates), and by 18% per annum since 1991. As a share of the world total, China’s merchandise exports have risen from 1.1% in 1981 to 6.8% in 2005 (or to 10.5% of world exports excluding intra-EU and NAFTA trade); last year China became the world’s third largest exporter, after Germany and the United States⁷.

If the growth rates of the past decade are sustained, China will overtake the US in 2007 and Germany in 2009.

Chart 3: China’s merchandise export performance



Source: IMF, Direction of Trade Statistics, and Economics@ANZ calculations.

⁷ Statistics in this and the next three paragraphs are from Statistics in this section are sourced from the IMF’s *Direction of Trade Statistics* database, accessed through Thomson Financial Datastream.

China's merchandise imports have likewise grown rapidly, at an average annual rate of 15% since 1981: with 6.1% of the world total China is also now the world's third-largest importer.

India's exports have risen at a 12½% annual rate since 1991, though from a much lower base, so that today India only ranks 24th among the world's exporters, with just under 1% of the global total.

China is now large enough, relative to the markets in which it trades, to affect the prices of the goods which it trades. As a generalization, China is pushing up the prices of the goods which it imports – mainly commodities; and pushing down the prices of the goods which it exports – mainly manufactured goods. India is doing the same, though to a much smaller extent, and in relation to services, rather than goods.

China's oil consumption has risen by 2.2mn barrels per day over the past five years (a growth rate of 8.6% per annum), accounting for 38.4% of the increase in global oil consumption and absorbing 28.6% of the increase in world oil production over this period. India is now the world's sixth largest oil consumer, and has accounted for 7% of the increase in global demand over the past four years. Yet China's oil consumption is still relatively low – 0.91 bpd per US\$1mn of annual GDP (cf 1.39 for Japan and 1.77 for the US), or 1.8 bpd per person – and is likely to continue growing at a rapid pace. India's is even lower, at 0.78 bpd per US\$1mn of annual GDP.

China's impact on the global coal trade has been even more striking. China is the world's largest coal user by a wide margin; rapidly increasing electricity generation has seen its coal consumption rise at an average annual rate of 14.2% over the past five years, accounting for 70% of the increase in global consumption over this period.

It thus seems almost unarguable that the demand for energy to fuel China's rapid industrialization and growth (and to a lesser extent that of India) has been an important, if not the most important contributor to the sharp rise in energy prices over the past few years: and that this effect will continue to be felt for many years to come.

China's rapid industrialization has also had a significant impact on the markets for a range of other metals and minerals. For example China is now producing close to 300Mt of steel annually, double the amount in 2001, and nearly three times as much as Japan. China has thus emerged as a major source of demand for iron ore and metallurgical (coking) coal.

China's imports of iron ore have risen at an average annual rate of 30% over the past five years, accounting for over 85% of the increase in global iron ore trade. Chinese imports of coking coal have jumped sharply from less than 0.5Mt pa prior to 2003 to 6.8Mt in 2004. Although this represents only 3% of total world trade in coking coal, China has accounted for one-third of the increase in coking coal trade over the past two years. Against a background of very tight supplies, Chinese demand has been a key contributor to the more than doubling of iron ore and coking coal prices over the past 12 months.

China's consumption of nickel has also trebled over the past five years, vaulting past Germany and the US to become the world's second largest consumer (after Japan) and accounting for 55% of the increase in global nickel use during this period.

China's demand for copper has risen 75% over the past five years, more than accounting for the entire increase in global demand (copper usage in the United States, which was the world's largest copper user until overtaken by China in 2001, has fallen by more than 12% over this period).

However, where China is, or has become, a significant net exporter of commodities the impact on prices has been rather different.

Aluminium provides perhaps the best illustration of this point. In 2004 China overtook the US as the world's largest primary consumer of aluminium; growth in Chinese demand has accounted for half the increase in global primary aluminium consumption over the past five years. However, Chinese aluminium production has risen at an even faster rate than consumption, so that China has been a net exporter of aluminium since 2002; in 2004 its net exports totalled 646,000 tonnes, as against net imports of 705,000 tonnes in 2000. China is also becoming a more significant producer of refined zinc.

This is the main reason why aluminium and zinc prices have risen by much less over the past few years than the prices of other metals, and indeed have fallen so far this year.

China's emergence towards the end of last year as a net exporter of steel products such as coil and wire has likewise exerted a significant downward effect on the prices of these products in 2005.

One of the most striking aspects of the current phase of rising commodity prices is that – in marked contrast to those of the mid- and late 1970s, for example – higher commodity prices have not led to rising prices for finished goods, and hence have not been reflected in higher inflation.

China provides part of the explanation for this, too, via its effect on the prices of an increasing range of tradeable 'finished goods' ranging from textiles, clothing and footwear to whitegoods and auto parts (of which China has become a net exporter for the first time this year). A study by Dresdner Kleinwort Wasserstein suggests that China has lowered America's inflation rate by almost a full percentage point in recent years (The Economist 2005, 65).

In short, what China is doing is changing relative prices. And it is changing relative prices in a way that is particularly beneficial to Australia. In simple terms, China is a net importer of (non-agricultural) commodities, and a net exporter of manufactured goods. Australia is the opposite: a net exporter of commodities, and a net importer of manufactured goods.

Indeed Australia is one of the few countries in the world whose principal exports are not at risk of being priced out of global markets by China – since China cannot conjure up reserves of coal, iron ore, nickel, natural gas etc. which it does not have. And Australia is also one of the few countries in the world which has little to lose from China's growing dominance of markets for the products which it can now or will eventually produce –

since (with a couple of exceptions) we have (to our very great benefit) exited those industries through our own program of unilateral trade liberalization.

It is thus no co-incidence that China's emergence as a significant influence on the global economy has been paralleled by a dramatic reversal in Australia's terms of trade – that is, the ratio of the prices we receive per unit of our exports to the prices we pay per unit of our imports.

Australia's terms of trade declined for most of the 20th century: together with our own economic mis-management this decline was a major reason for Australian living standards falling from about the highest in the world at the beginning of the 20th century to around 19th by 1990.

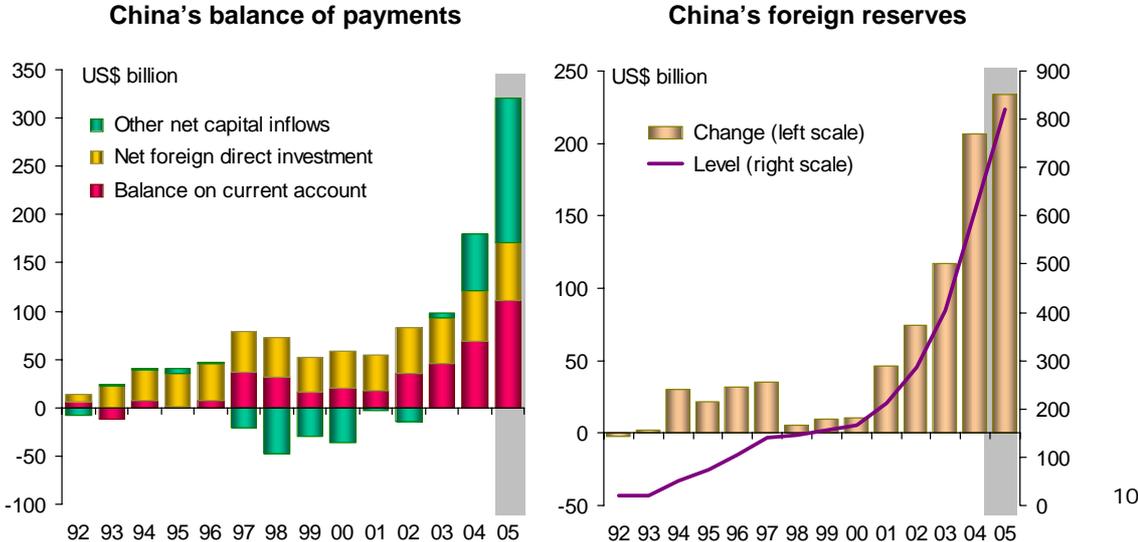
Over the past ten years, however, the average unit price of Australia's exports has risen by 27½% in US\$ terms (ie, abstracting from fluctuations in the value of the A\$), while average unit price of our imports has fallen by 8% in US\$. As a result, over the past decade Australia's terms of trade have improved by almost 40%, to their most favourable since the March quarter of 1974.

Together with the dramatic improvement in the quality of Australian economic management since the mid-1980s this improvement in the terms of trade has contributed to a recovery in Australians' standard of living from 19th in 1990 to 8th in 2004.

Given the long-term relationship between Australia's terms of trade and its exchange rate, the emergence of China as a key influence on the relative prices of globally traded goods can thus also be said to have been a major contributor to the recovery in the value of the Australian dollar from its lows of 2000 and 2001.

China's impact on the Australian dollar is of course just one aspect – and a very small one at that – of its growing influence on global financial markets. Until 2003, China's current account surpluses were typically quite small, averaging less than 2% of GDP between 1990 and 2002 and exceeding 3% of GDP (at market exchange rates) in only four years. Over the past two years, however, China's current account surplus has mushroomed, reaching US\$70bn (4.2% of GDP) in 2004 and on track to exceed \$100bn (5% of GDP) this year (Chart 4).

Chart 4: China's balance of payments and foreign reserves
 Sources: China National Statistics Office; Institute for International Finance.



On top of this China has attracted a large and growing volume of foreign direct investment – exceeding US\$50bn per annum in recent years – and, more recently, a rising tide of portfolio and other capital inflows, which topped US\$56bn in 2004. A good deal of the latter appears to have been driven by market expectations of an imminent revaluation of the renminbi.

A country running a large current account surplus and attracting significant net private capital inflows under a flexible exchange rate regime would almost certainly see its exchange rate appreciate. But China maintained a fixed exchange rate regime from 1994 until the end of July this year, so that swings in the net balance of its current account and private capital flows were instead mirrored in its levels of foreign exchange reserves.

In order to maintain the exchange rate fixed at Rmb8.28 to the US dollar, the People's Bank of China has 'printed' and sold over Rmb 3 trillion of its own currency since the end of 2002, in exchange for an equivalent amount of foreign currency, and thereby lifting its foreign exchange reserves from US\$286bn to US\$711bn as of June this year.

Since most of these reserves are held in US\$, the PBoC (in company with Bank of Japan and other Asian central banks) has been financing a large share of the US Budget deficit. This has in turn helped to keep US government bond yields and other long-term interest rates down, in circumstances where the more than trebling of the US cash rate since June last year might have been expected to result in higher long-term interest rates.

In effect, the People's Bank of China, in company with other East Asian central banks, have been running what could be described as the greatest vendor financing scheme the world has ever known: lending to American consumers, via the US budget, the money that American consumers need to keep borrowing so that they can keep buying the products that East Asian economies need to keep selling to them so that they, in turn, can keep growing at the rates to which they have become accustomed.

China's move at the end of July from a rigid peg to the US dollar to a 'managed' peg to a basket of currencies (and the other developments which have been announced since) is an important change along the road to a more flexible exchange rate regime, but it does not amount to a retreat from China's strong preference for exchange rate stability.

Although China may allow further movements in the renminbi against the basket, and although movements in the US\$ against other currencies in the basket should, in principle, be reflected in movements in the renminbi against the US\$, it is unlikely that China will entertain any significant appreciation of the renminbi in trade-weighted terms over the next few years.

The exchange rate regime which China has adopted is similar in some respects to the one which Australia used between 1976 and the floating of our own exchange rate, with the important differences that:

the weighting of the various currencies included in the basket is not known, and that the PBoC is 'managing' the renminbi 'by reference to' this basket rather than allowing fluctuations in the values of the various currencies in the basket to be

automatically reflected in changes in the exchange rates between the renminbi and individual currencies such as the US dollar.

Rightly or wrongly, the Australian Government of the time (the Fraser Government) did not consider Australia's financial system strong enough to cope with a freely floating exchange rate. Rather, senior economic advisors to that Government who in other respects were fervent advocates of a greater role for market forces in the Australian economy, (rightly or wrongly) saw control of the exchange rate as a useful instrument of economic policy, just as China's do today.

The Fraser Government's position may well have been influenced by the experience of a few years earlier when Australia found itself in the highly unusual (for Australia) position of running a current account surplus, and attracting significant short-term capital inflows speculating on the possibility of a revaluation of the Australian dollar.

The government which was in power in Canberra until December 1972 – under pressure from interests representing Australian farmers – refused to allow a revaluation of the Australian dollar, with the result that growth in Australia's money supply accelerated to a peak of over 25% per annum during 1973. This massive monetary expansion in turn helped fuel a bout of double-digit inflation which peaked at 17.6% in early 1975, and which lasted for four years.

There are some obvious parallels between this Australian experience of three decades ago and that which China has been confronting in recent years.

Were China to move immediately – or even over an interval of a few years – to a freely floating exchange rate with free cross-border capital flows, it is just as likely that the renminbi would fall as rise, as Chinese savers sought to withdraw their savings from domestic banks of (currently) dubious solvency, in favour of overseas investments.

More than anything else, this reality explains why the Chinese authorities regard reform and recapitalisation of the banking system as more important than, and a pre-requisite for, the adoption of a more flexible exchange rate system.

Conceptually, the Peoples' Bank of China can continue to purchase enough US\$ to prevent any appreciation of the Rmb against the US\$ indefinitely (since – in direct contrast to the position of, for example, the Bank of Thailand in mid-1997 or Argentina's BCRA during 2001 – it controls the supply of the currency it needs to sell).

However, the People's Bank of China's foreign exchange strategy is not without costs or risks:

- first, to the extent that the PBoC 'sterilizes' its US\$ purchases through sales of Chinese government bonds or its own paper, there is an on-going cost arising from the fact that interest rates on yuan-denominated instruments are higher than those on US Treasury securities.

- second, the PBoC is exposed to a growing risk of capital losses in the event that the Rmb is eventually revalued: at the June 2005 level of reserves, a 10% revaluation of the Rmb would cost the PBoC some \$71bn, equivalent to 4¼% of GDP⁸.
- finally, and most importantly, the scale of the PBoC's foreign exchange operations complicates the task of domestic monetary policy, by expanding the domestic monetary base to the extent that it is not able to 'sterilize' the liquidity impact of its US\$ purchases. Thus, the PBoC's FX operations have significantly boosted the liquidity base of the banking system, fuelling rapid growth in bank lending, which has in turn contributed to a significant increase in real estate investment, much of it speculative in nature.

Although PBoC 'window guidance' to banks to curb lending to property developers, combined with the imposition of provincial or municipal capital gains taxes on speculative real estate investments, appears to have had some effect in dampening upward pressure on real estate prices during 2005, one of the key risks confronting the PBoC is that its foreign exchange operations may fuel an unsustainable asset price bubble.

In some respects, the PBoC is in a similar position to that of the Bank of Japan in the aftermath of the Louvre Accord of February 1987, with the difference only that the Bank of Japan's efforts to prevent the US\$ falling below ¥120 were in accordance with US pressure to do so, rather than despite US pressure to do the opposite. Japan's FX reserves doubled between February 1987 and December 1988 as the BoJ intervened to put a floor under the US\$ (and a ceiling above the yen); during this period the Japanese share and land price bubble entered its final, manic, phase.

The 1980s Japanese asset price bubble came to an end when a newly installed Governor of the BoJ, Yasushi Mieno, took the view that the bubble was undermining the egalitarian basis of Japanese society (by encouraging belief that the way to improve one's financial position was by speculating with borrowed money, rather than by working hard and saving), and – despite the fact that inflation remained well under control - kept raising interest rates until the bubble burst, in December 1989.

It is plausible that a similar view could at some point be adopted by the PBoC if property prices in Chinese cities were to continue rising at a rapid pace, further widening perceived inequalities between the coast and the interior and possibly giving rise to resentment and social unrest among the majority of the population who are unable to become richer in this way. Indeed such resentment could lead to widespread questioning as to whether the Chinese Communist Party (CCP) should retain a monopoly of political power. The CCP has already shown (in June 1989 and afterwards) that is more than willing to pay almost any price – including an extended economic downturn – to avoid such questions being widely asked.

Such a decision seems unlikely to be necessary, or contemplated, ahead of the 2008 Beijing Olympics.

⁸ Based on calculations by Setser and Roubini (2005, 196).

Any subsequent decision by the PBoC to discontinue its policy of doing 'whatever it takes' to prevent a rise in the Rmb against the US\$ (a decision which would likely be mirrored by other Asian central banks) would undoubtedly have significant consequences for the financing of the US budget and current account deficits, and hence for US long-term interest rates and asset prices. In that sense, it is difficult to understand why US legislators and officials are so anxious to have the PBoC embark on precisely such a course.

All of which illustrates the point that the world has rarely responded rationally to the rise of a new economic power. As Kagan observes, "rarely have rising powers risen without sparking a major war that reshaped the international system to reflect new realities of power ... There is no reason to believe that we are any smarter today than the policymakers who mismanaged the rise of Germany and Japan" (2005).

There are, however, plenty of reasons to hope that we are smarter than those policy makers – the benefits to Australia being not least among them.

While China's rapid economic growth and industrialization is unequivocally beneficial to Australia, in the same way as Japan's rapid growth and industrialization thirty years earlier was enormously beneficial to Australia, it raises political and strategic questions that Australia never confronted in the context of its relationship with Japan or other East Asian countries.

China is not, and probably never will be, a strong ally of the United States.

On some issues – such as the containment of international terrorism, or deterring North Korea from acquiring nuclear weapons – China's and the United States' interests coincide; but on others, their interests diverge. But China is increasingly seeking a role in regional and global affairs commensurate with its population and growing economic weight.

Almost inevitably, this means there will be issues and areas in which its interests and those of the United States conflict. All of us – including, I presume, China and the United States – hope that such conflicts, if and when they do occur, will be resolved peacefully.

But it also possible, perhaps even likely, that Australia may on occasion have to make choices between our commercial and economic interests, on the one hand, and our strategic interests, on the other – in a way that has never arisen in our relationship with Japan.

The pattern of growth and development being followed by India is less complementary to Australia's economy. India's pursuit of global dominance in services industries – such as information technology and business process outsourcing – has little impact on the demand for Australia's principal commodity exports; but does potentially put at risk jobs in Australia's services industries, which account for over 70% of total employment, just as it potentially does services sector jobs in other advanced economies.

Nonetheless, a more prosperous and wealthier India will undoubtedly be a positive influence in the region and for the world. Partly because it is a democracy, India's

interests are less likely to conflict with those of the United States than China's – a point which has already not escaped the attention of leading US policy-makers.

India's rapid growth thus serves to remind Australians that, even as we become more economically dependent on China, and its seemingly insatiable thirst for our resources, we will need to continue to deepen and strengthen our economic, political and cultural ties with other Asian nations, including India, but also our long-standing friends and trading partners elsewhere in East Asia.

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