

FOCUS



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No easy end to ongoing China-Australia tensions

The China-Australia bilateral relationship deteriorated sharply over 2020, with China imposing both formal and informal trade restrictions on a number of Australian exports, including coal, barley, beef, wine, cotton among others. However, despite China's trade action, the Australian economy continued a solid recovery from the pandemic, registering two consecutive quarterly GDP growth in the second half of 2020 as business conditions move towards normality following an easing of containment measures. We expect Australia's GDP to be back to 2019 level as soon as this year. Chinese trade restrictions so far have a muted impact on the broader Australian economy due to two main factors: first, the ability of some affected sectors to find alternative markets, such as Saudi Arabia for barley, and Southeast Asian countries for cotton, and second, top exports such as iron ore and natural gas were not targeted by China. But there are growing concerns that an escalation of bilateral tensions will see China hardening its stance towards Australia and possibly start targeting Australian services exports, particularly in tourism and education which could see 2% of Australia's GDP at risk. With both sides interpreting the dispute through the lens of national sovereignty, the situation is unlikely to improve any time soon. Future development of China-Australia tensions will be closely monitored by Asian countries for guidance as to the extent of economic damage potentially suffered should they be caught in a similar situation.

Bilateral relations may worsen further

Bilateral relations between China and Australia were at a high point six years ago when Chinese President Xi Jinping made a state visit and addressed the Australian parliament in November 2014. Both countries agreed to elevate the relationship to a 'Comprehensive Strategic Partnership', and also later concluded a free trade agreement in June 2015.

The turning point in the bilateral relationship was in December 2017 when then-Australian Prime Minister Malcolm Turnbull warned about foreign interference in Australian politics, commissioned a classified report into

the issue and, soon after, announced new legislation in mid-2018. Several months later, Australia announced that it would exclude Huawei from the development of its 5G network.

Trade relations between China and Australia deteriorated when Australia's Anti-Dumping Commission extended anti-dumping duties on Chinese stainless steel sinks on 28 February 2020 following an investigation into Chinese aluminium extrusions. Between March and July last year, there were a further eight anti-dumping actions against Chinese products, such as steel¹. On 19 April 2020, Australia pushed for a call for an investigation into the origins of coronavirus, adding to pressure on China over its handling of the Covid-19 outbreak. During

May 2020, China imposed anti-dumping and anti-subsidy duties on Australian barley imports into China, citing investigations that started in 2018. China subsequently imposed tariffs on other Australian exports, such as wine, as well as formal and informal bans on products ranging from beef and timber to cotton and coal (**Table 1**).

TABLE 1
China's recent actions on Australian exports

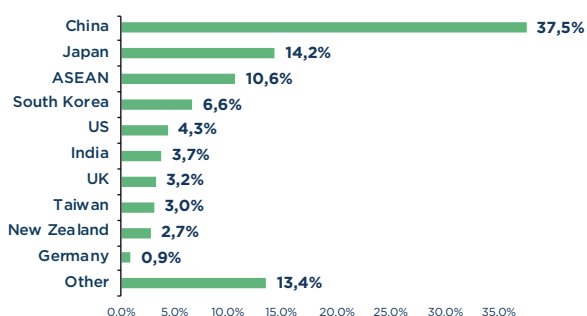
DATE	PRODUCT	ACTION
May-20	Barley	Anti-dumping and anti-subsidy duties totalling 80.5%
May-20	Beef	Halts beef imports from four of Australia's largest meat processors
Aug-20	Wine	Launches anti-dumping and anti-subsidy probes on some Australian wines
Sep-20	Barley /Wheat	Suspends barley imports from CBH Grain (Australia's largest grain exporter) Orders stricter inspections of Australian wheat and barley
Oct-20	Coal	Reportedly verbally instruct buyers to avoid Australian coal supplies
Oct-20	Cotton	Orders Chinese mills to stop buying Australian cotton supplies or risk a 40% tariff
Nov-20	Wine	Temporary anti-dumping measures on Australian wine imports (from 28 Nov)
Nov-20	Coal	Finds Australian coal imports failed to meet environmental standards
Nov-20	Copper	Reportedly instruct buyers to avoid Australian copper ore and concentrate
Nov-20	Barley	Bans shipments from Australian-based grain exporter Emerald Grain
Nov-20	Lobster	Imposes new live seafood inspections, include checks for traces of minerals and metals
Nov-20	Timber	Bans timber from Australian states Victoria and Queensland due to detection of pests and biohazards
Dec-20	Wine	Temporary anti-subsidy measures on Australian wine imports

The Chinese embassy in Australia also published a list of 14 grievances² in November 2020, framing the current deterioration in relationship as a consequence of Australia's behaviour and action. The China-Australia bilateral relationship is multi-facet, ranging from national security, economics and trade to foreign policy and domestic politics. But the primary perspective in which both sides are framing the relationship involves 'sovereignty'. Australia is concerned with fending off Chinese influence on Australian politics and other threats to its national sovereignty, while China viewed Australia's criticism on its action in Hong Kong or human rights record as an infringement on Chinese sovereignty and national interests. From a standpoint of sovereignty, both sides are unlikely to back down, suggesting that the current situation is at risk of escalating.

Muted impact on Australia's economy so far

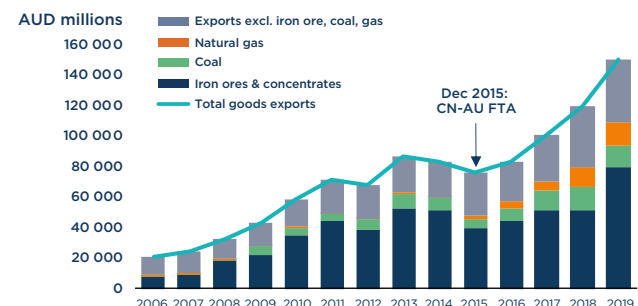
Exports are increasingly important to Australia, with the value of exports exceeding the domestic private sector (excluding households) since 2015. The total value of exports in the December quarter of 2019 was \$107.1 billion³, compared with the non-household private sector at \$84.9 billion. Exports also now account for a quarter of the Australian economy, up from 20% in 2000. The key reason for rising Australian export volumes is demand from mainland China. Over the past couple of decades, China has become Australia's largest export market (**Chart 1**).

CHART 1
Top export destinations for Australia (2018-20)



From just over 5% of total exports in 2000, the share of Australian exports to China rose to 38% in 2019. However, nearly half of all exports to China are iron ore (**Chart 2**). The strong demand for steel as a key input in infrastructure building in China is consistent with rising Chinese imports of iron ore. China imports 60% of iron ore from Australia, which significantly surpasses the next biggest import source, Brazil. After iron ore, the next two largest Australian exports to China are natural gas and coal. Major exports from Australia to China are dominated by non-rural commodities, which account for well over 70% of total shipments to China. In contrast, agricultural commodities, which have so far been the main target of China's trade action, amount for less than 10%.

CHART 2
Top Australian goods exports to China



With China taking more than one-third of Australia's total exports, rising trade tensions are seen as a potential threat to Australia's economic outlook. However, iron ore, the mainstay of Australian exports to China, has been spared in the ongoing trade dispute, due to a lack of suitable alternatives.

The bulk of the products impacted by Chinese trade action is concentrated in agricultural commodities, with the exception of coal. While significant to individual businesses in the affected sectors, the current impact is unlikely to be sufficiently large to undermine the Australian economic recovery. The Perth USAsia Centre at the University of Western Australia (UWA)⁴ estimated that \$19.3 billion of merchandise exports (4% of total exports of goods and services in 2018-19) are affected.

Australia's merchandise exports fell 6.9% in 2020, with the increase in iron ore shipments (+14.5%) partially offsetting the sharp declines in coal (-31.6%), petroleum products (-30.2%), and natural gas (-24.8%). However, there is great difficulty distinguishing the degree of negative impact on Australia's trade sector between Australia-China trade tensions and effects of measures taken to contain the Covid-19 pandemic.

Alternative markets

The impact of the Chinese trade restrictions varies across agricultural subsectors, with several factors influencing the outcome, including success in finding or expanding alternative markets, supply conditions, and China's market share in the industry. For example, barley farmers coped surprisingly well as they were able to increase sales in the Middle East and other parts of Asia, while cotton growers are making inroads into markets such as Indonesia, Thailand, Vietnam and Bangladesh to diversify its export markets.

Barley

China is the largest export market for Australian barley, accounting for 70% of all barley exports on average in 2017-2019. The next largest export destinations is Japan, while smaller markets exist in the Middle East and Southeast Asia.

1 - <https://www.reuters.com/article/us-australia-steel-china-idUSKCN0XK05C>

2 - <https://www.smh.com.au/world/asia/if-you-make-china-the-enemy-china-will-be-the-enemy-beijing-s-fresh-threat-to-australia-20201118-p56fqs.html>

3 - All dollar value in Australian dollar unless otherwise stated

Australia's barley growers were able to open up new markets in South America and the Middle East. They secured a barley tender in Saudi Arabia, the world's second largest importer after China. The Middle East is a large market for barley for animal feed, so there are opportunities for Australia to make further inroads into this region. Meanwhile, Australia has begun a trial to sell premium malting barley to Mexico's beer production industry.

Beef

China is an important market for Australia's beef sector and accounted for nearly 20% of all Australian beef exports. China suspended six Australian abattoirs from the trade over labelling issues and claims of meat contamination, which has had a large impact on the industry. Data from Australia's Department of Agriculture showed a 35% decrease in export volumes of beef and veal to China in 2020, falling from 300,032 to 196,696 kilograms. However, part of the reason is also connected to the pandemic which affected the premium restaurant trade, as well as domestic supply constraints as two years of drought brought the national cattle herd to a 20-year low. Farmers have since been rebuilding herds, which limited exports.

Cotton

The Australian cotton export sector is worth about \$1.8 billion annually, with China accounting for nearly half of all Australian cotton shipments on average in 2017-2019. The impact of China's restriction was not felt immediately as the country has lower stocks for sale after a prolonged drought led to record low production. The country's cotton farmers are now working to boost demand from Vietnam, Thailand and other Asian countries.

Wine

Over 60% of wine produced in Australia is exported, and China was Australia's biggest wine export market, taking in about a third of all Australian wine. Between 2009 and 2019, China's imports of Australian wine rose almost tenfold from \$132 million to \$1.2 billion. Following China's trade action on Australian wine in November 2020, the value of wine exports to China fell 94% to \$5 million in December, down considerably from an average of \$90 million during January-November. The next two biggest markets are the US and the UK, and Australian winemakers are looking to increase buying from these two countries.

Rock lobster

The Australian seafood industry exports nearly 95% of all rock lobsters to China, a trade that's worth half a billion US dollars annually. The monopsony condition means that finding alternative markets for lobsters is a great challenge. So far, Chinese demand has been replaced to a large extent by domestic demand after Australian authorities amended the law to allow commercial rock lobster fishers to sell large quantities of their catch from their boats during December and January.

Coal

According to the Global Times, China is allowing the country's power plants to import coal without clearance restrictions from several countries except Australia⁵, imposing an unofficial ban on China's imports of Australian coal. In 2019, Australia exported \$13.7 billion worth of coal to China, which is the second-largest export destination for Australian coal, accounting for around one-fifth of all Australian coal exports on average in 2017-2019. Other major markets for Australian coal are Japan (28%), India (16%), South Korea (11%) and Taiwan (8%), where together they make up nearly two-thirds of all Australian coal exports.

In 2020, Australia exported \$44 billion worth of coal in total, down sharply (-32%) from \$64 billion in 2019. Coal producers will look to shift their orders to the other large markets, such as Japan and South Korea, in the short term, with Vietnam also becoming an important buyer. However, longer-term trends such as a move towards carbon neutrality, a goal set by top customers such as Japan and South Korea, alongside plans by China and India to reduce thermal coal imports, as well as competition from natural gas are secular challenges facing Australian coal producers.

Implications for Australian businesses

The current dispute exposed Australian businesses, in particular exporters, to a significantly higher level of risk in the China market. The recognition of increased vulnerability from Chinese trade actions due to a heavy reliance on China will impose a greater sense of urgency on Australian businesses to diversify to other export markets and exercise more caution about exporting to Chinese markets. As shown earlier, market diversification has already been forced upon businesses in affected sectors.

CHART 3
Selected exports subject to China's restrictions

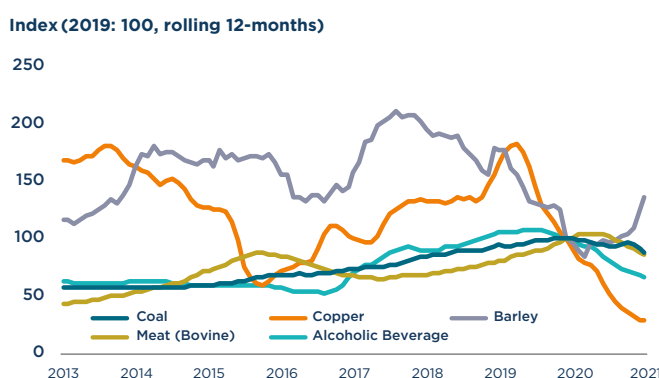
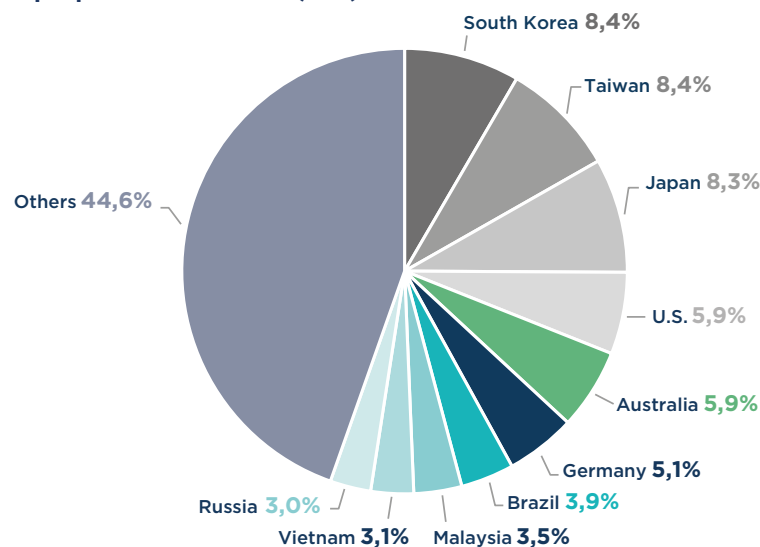


CHART 4
Top import markets for China (2019)



China's economy unaffected by restrictions on Australian imports

Australian imports to China make up less than 1% of the China's GDP, suggesting that recent Chinese trade action is unlikely to have any significant impact on China's economy, though there could be some sector-specific impact. In fact, China was the only major economy to register GDP growth in 2020 at 2.3%, with the authorities expecting an expansion of at least 6% in 2021. In many cases, China was able to diversify the affected imports to alternative markets through increasing buying, such as US coal and Argentinean beef, though this diversification sometimes comes with higher prices.

Coal

The informal ban on Australian coal in September 2020 exacerbated a supply shortage as China was already short of thermal coal (for electricity generation), and power companies were instructed to import from markets other than Australia, who is China's biggest supplier. To tap into alternative sources, Chinese importers had to pay a USD 100 premium for US coal over Australian prices, according to Argus, a commodity-pricing service provider⁶.

Beef

Beef imports were up 28% in 2020, with Brazil and Argentina the two top suppliers to the market, accounting for 57% of all beef imports. Australia is the third largest beef supplier, but its share of the market has dropped from 19% to 13% in 2020 as export volume of frozen beef dropped 39%. This shift in China's market share is linked to an increasing reliance on South American suppliers while Australia's supply shrank. Concerns over the food safety of imported meat, including beef, have also led to a shift in demand towards domestically produced meat among Chinese consumers and restaurants, contributing to slower growth in meat imports.

Barley

Despite increased tariffs on Australian barley, the largest supplier to China, the volume of China's overall barley imports rose 36% in 2020 from 5.9 million tonnes to 8.1 million tonnes as the country increased purchases from other major barley suppliers, such as Canada and France. According to official data, Canada shipped 1.5 million tonnes of barley to China between August and December 2020.

6 - <https://www.wsj.com/articles/chinas-coal-war-with-australia-fuels-shortage-at-home-11612953005>

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What's next?

China's trade actions towards Australia is not uncommon, and follows a pattern of Chinese economic retaliation against countries in which it found itself in a political or security dispute. The most recent example was the economic action taken by China towards South Korea in 2016-17 over a US-South Korea agreement to deploy a missile defence system (THAAD). The dispute lasted for just over a year, from September 2016 to November 2017, with China blocking market access of South Korean businesses in a range of sectors, including media, consumer products and tourism, to compel Seoul to abandon the THAAD deployment. While the THAAD system remains in South Korea, Beijing managed to secure assurances of military constraints from Seoul in return for the lifting of China's economic actions.

The current dispute between China and Australia is based on a more complicated (and sometimes vague) issue relating to sovereignty rights, which makes a quick resolution unlikely. Furthermore, Australia's involvement in the so-called 'Quad' countries, widely seen as an US-led informal coalition to contain China, is looked upon unfavourably by China, and expected to raise tensions further in the China-Australia relationship.

In our baseline scenario, bilateral tensions are expected to be prolonged in the near term, with a rising risk of further Chinese retaliation, particularly in Australia's international education and tourism sectors, as economies reopen their borders to international travel. In June 2020, China's Ministry of Culture and Tourism warned about travelling to Australia, while the Chinese Ministry of Education issued a warning on studying in Australia in June, and repeated its warning in February 2021. The Perth USAsia Centre at UWA estimated that \$28 billion worth of services exports in tourism (\$16.3 billion) and education (\$12.1 billion), where both together accounted for 6% of total exports, to be at risk of further Chinese retaliation.

Together, the international education and tourism sectors accounted for 5% of GDP, and employ 906,000 people (6.8% of Australia's workforce). China is the top market for these two sectors, accounting for 32% and 42% of Australia's education-related services and tourism service exports respectively in 2018-2019, suggesting that further China's trade action against these services exports have the potential to harm the Australian economy by up to 2% of GDP. The economic damage could be even higher if we consider potential job losses in these two sectors. Furthermore, Chinese demand in these two service sectors would be more difficult to replace when compared to agricultural and mineral commodities. Beyond trade, China may escalate the dispute via the foreign direct investment (FDI) channel. However, this is unlikely because any negative impact on Australia's economy from reduced Chinese FDI is expected to be much lesser compared to trade since China is not a major investment source. The leading sources of foreign investment into Australia have been the US and the UK, accounting for over 40% of total investment in Australia in 2019, while mainland China is the ninth largest foreign investor, with 2% of the total.

The future development of China-Australia dispute will be closely monitored by regional countries, in particular those with a significant reliance on China for investment and trade. Furthermore, amid the ongoing strategic competition and political differences between the US and China, Asian countries will be hard-pressed if they are forced to choose between the two sides.