HSBC Global Research

Macro
Economics – Australia
July 2014

Australia's growing links to Asia

Powering growth

- Australia's economic relationship with Asia continues to deepen
- Trade and population links between the two are already strong and getting stronger
- While financial ties are more limited, these too should grow as Asia's financial system matures

By Paul Bloxham

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Metrics to make you think

- **In the past six years, Australia's economy has grown 16%. By comparison, the US has grown 6%, while the British economy has not grown at all and Europe's is 2% smaller. China's economy has grown by 65%.**
- **No other OECD economy has a larger export exposure to Asia than Australia and the largest part of this is to China.**
- **Around 73% of Australia's exports go to Asia, and we expect this to rise to 80% by 2020e.**
- **Three Asian economies alone – China, Japan and Korea – account for 54% of Australia's exports.**
- **Much of what Australia exports are commodities, which account for 57% of total exports.**
- **Over the next six years the value of iron ore exports is expected to rise 54%, coal by 41% and LNG by 330%, as newly built capacity comes on line.**
- **Other goods and services account for 40% of Australia's exports, which include agricultural products, manufactured goods, and tourism and education services.**
- **Chinese tourist visits to Australia have increased by 110% in the past four years.**
- **28% of Australia's population was born outside the country.**
- **Of the more than 5m foreign-born individuals living in Australia, 2m were born in Asia.**
- **Thanks to strong migration, Australia's population growth has averaged 1.4% y-o-y over the past decade, compared to an average of +0.7% y-o-y amongst the OECD economies.**
- **Australia's financial ties are still mainly to Western markets, with 56% of FDI and 57% of ODI with the US and Europe, although links to Asia are growing.**

Sources: ABS, BREE, CEIC, DFAT, OECD, HSBC estimates

Australia's pivot to Asia

Strong ties to Asia have been a key driver of Australia's relative economic success in recent years. In our view, this story is not over yet. Trade links are still growing, with a further ramp-up in exports of iron ore, coal and LNG on its way, and we expect rising demand for Australian food, tourism and education as Asia's middle class incomes rise. Australia's population is becoming more Asia-integrated due to strong migrant flows, which should also help to facilitate greater trade and financial ties. While direct financial linkages to Asia are still small, we expect them to strengthen as Asia's financial system matures. Growing links to the fast-growing Asian economies are a key reason for our continued optimism about Australia's growth prospects.

Back in 1966, historian, Geoffrey Blainey, famously wrote that Australia's geographical remoteness had shaped its economy, its history and its identity in a book titled 'The Tyranny of Distance'. In this reading of history, Australia had suffered because of its distance from Western markets. Almost 50 years later, things are different. Australia is no longer 'cursed by the tyranny' of distance, but blessed by the power of proximity to the fastest growing economies in the world, in Asia.

Today, no other OECD economy can boast a larger export exposure to Asia than Australia. Around 73% of Australia's exports go to Asia. This is not inconsequential. Indeed, these strong ties have been a key driver of Australia's recent relative success. In the past six years, Australia's economy has grown by 16%. By comparison, the United States has grown by only 6%, while the British economy has not grown at all and Europe's is 2% smaller.

A key reason for Australia's outperformance has been strong demand for hard commodities, particularly from China. In its initial phase, this drove a sharp rise in commodity prices, which boosted Australian incomes. The next stage saw an investment boom, which made the mining sector the main driver of GDP growth at a time when most advanced economies were languishing. Now, although mining investment is falling, the ramp-up in resources exports is only just beginning and most of these newly produced commodities are destined for Asian markets. The mining story is not over yet and we expect the ramp-up in iron ore, coal and LNG exports to see 80% of Australia's exports heading to Asia by 2020.

But Australia is more than just a big mine. Indeed, mining accounts for only 10% of value-added and less than 3% of jobs. The bulk of Australia's economy is the services sector. Therefore, in addition to exporting commodities, Australia is expected to have opportunities to export other things to Asian consumers that are rapidly getting wealthier. We expect this to see increased demand for Australian food, tourism, education and business services. These already account for 30% of Australia's exports and there are signs that they are already picking up. Chinese tourist visits to Australia have increased by 110% in the past four years and, after a number of years in decline, international student enrolments are also on the rise. Australia has long been a large exporter of wheat, beef and dairy products, with most of these exports already heading to Asian consumers.

Australia also has strong population links to Asia. Since the mid-1980s migration to Australia has been dominated by arrivals from Asia. In the recent years, the number of migrants from China and India has overtaken those from the more traditional source of Great Britain. Of the more than 5m foreign-born people living in Australia, 2m were born in Asia. Strong migration flows have helped Australia maintain a population growth rate that is twice the OECD average. Because of entry criteria, migrants are typically younger and better qualified than the extant population, so they are helping to boost Australia's potential growth rate.

Despite these strong trade and population connections, financial flows directly from Asia remain comparatively small. Foreign capital still mostly comes from Western markets with the US and Europe accounting for almost 60% of total foreign investment in Australia. This partly reflects historical and cultural ties as well as greater depth of these developed financial markets. To many Western investors Australia is also a platform for exposure to Asia's growth story. As Asian financial markets mature we expect direct financial links to also grow. Already strong population and trade links should help to facilitate growing financial ties.

Of course, making the most of these opportunities requires good policy. Australia has a comparative advantage in production of hard commodities and energy; however, it is less clear that it has an advantage in exporting services or agricultural products. Policymakers can play a role by reducing trade barriers to help support access to foreign markets, providing sufficient infrastructure, lowering barriers to entry, reducing regulations, encouraging innovation and helping support the development of capital markets to fund new activity. Businesses also have a critical role to play as new opportunities are usually exploited by the private sector.

Some commentators have become increasingly downbeat about Australia's economic outlook, but we remain optimists. We expect GDP growth to be 2.8% in 2014, rising to 3.2% in 2015. Australia's long pivot towards Asia is far from over and we expect it to continue to support growth.

Contents

Australia's strengthening trade connections to Asia

- Australia's trade with Asia has been rising for most of the post-WW II period and we expect it to increase further
- Australia has gone from 'living off the sheep's back' to being a significant miner of industrial commodities and is expected to soon become a significant global energy exporter
- As Asian middle class incomes expand, demand for Australian food, education, tourism and business services is set to rise

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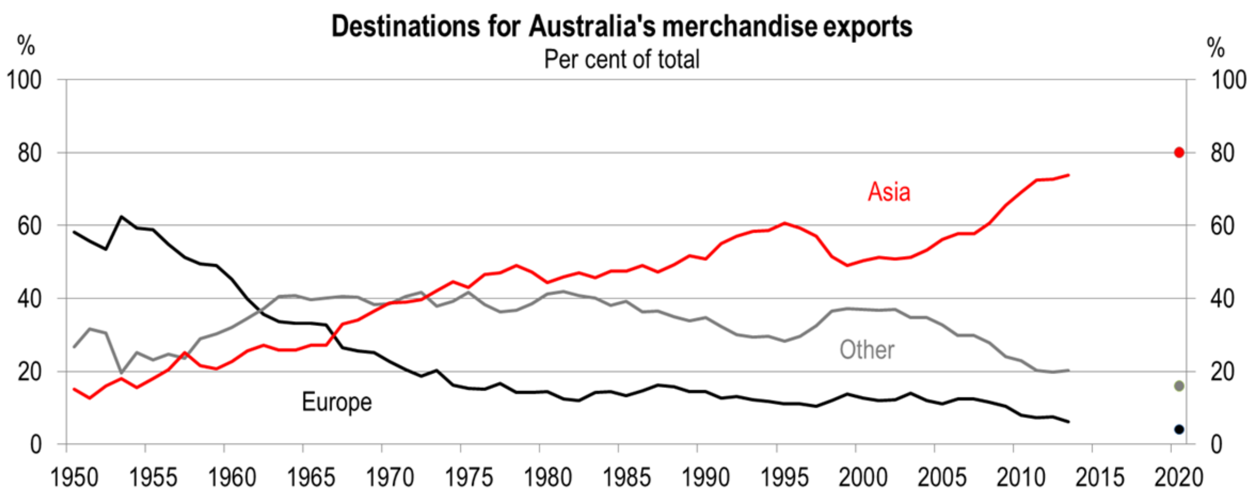
A long pivot towards Asia

Asia dominates Australia's trade flows and has done so for quite some time. Exports to Asia overtook other regions in the mid-1970s (Chart 1). Prior to this, Australian exports mostly went to Britain, reflecting historical ties. In 1900, 53% of Australia's goods exports went to Britain, most of which was wool. That share has trended lower since then, with the Britain taking only 2.5% of Australia's exports currently.

1. Australia's exports have seen a long pivot towards Asia



Source: ABS, RBA, HSBC estimates

The discovery of hard commodities and industrialisation of Asia drove a ramp-up in exports to Asia from the mid-1950s. Japan's industrialisation and the removal of trade barriers from 1957, saw it quickly become Australia's largest Asian export market.

Australia's exports also shifted from rural products to resources (Table 2). In 1950, rural products still accounted for almost 90% of Australia's exports, largely wool, but by 1980, wool was less than 10%, while coal and metals were over one-third. By 2013, metals and energy accounted for 57% of total exports and rural exports were only 12% (wool was 1%).

2. Australia exports by type (% of total, in values)

	1950*	1980	2013
Rural	**89**	**34**	**12**
- Meat	3	7	3
- Cereals	13	12	3
- Textile fibres	65	8	1
- Other rural	8	7	5
Resources	**4**	**33**	**57**
- Coal	–	7	13
- Iron ore	–	5	19
- Metals	4	19	17
- Other	–	2	8
Manufactures	**–**	**9**	**10**
Services	**NA**	**15**	**17**
- Tourism	NA	4	4
- Education	NA	NA	5
- Other services	NA	NA	8
Other	**7**	**15**	**3**

Source: ABS, DFAT, RBA. *Merchandise exports only

As Chart 1 shows, Australia's exports to Asia took a significant hit during the Asian financial crisis of 1997, with the share of its goods exports going to Asia falling from 60% to 50%. Nonetheless, Australia fared reasonably well, as it re-directed commodity exports towards Western markets, particularly the United States. It did, however, take over a decade for the share of Australian exports to Asia to recover to their pre-Asian financial crisis level. By that point, Australia's exports story was being driven by a new Asian giant: China.

China's rise

China's rise to become Australia's largest export market has been rapid. As recently as 2000, China was just a small player, taking only 5% of Australia's exports. By 2010, China had overtaken Japan to be Australia's largest export market and it now accounts for 32% of goods and services exports.

The rise of China's share of Australia's exports has been far more rapid than Japan's. Australian goods exports to Japan rose by 30ppts of the total, from 5% of exports in 1950 to a peak of 34% of exports in 1977, as Japan industrialised and its demand for hard commodities grew (Chart 3). China has achieved the same feat in less than half

3. China's rise was far more rapid than Japan's and has further to run

Source: ABS, RBA, HSBC estimates

the time. China's share of Australia's exports is also set to rise further, as the recent mining investment boom delivers a further ramp-up in iron ore, coal and liquefied natural gas to the Chinese and other Asian markets in coming years.

Australia's exports to Asia currently account for 73% of total goods exports. We expect this to rise to 80% of goods exports by 2020, with China expected to account for 40% of Australia's exports by then. China is expected to remain Australia's single largest trading partner for the foreseeable future.

Australia's strong ties to Asia and China's rise have been a key reason for Australia's relative outperformance since the global financial crisis. Australia was one of the few nations to continue to grow in 2009, despite the global financial crisis. Indeed, Australia's economy is now 16% larger than it was six years ago, while the US economy is only 6% larger and Europe is 2% smaller. By comparison, China has grown by a substantial 65% over the past six years.

China's strong demand for commodities drove Australia's success, having boosted incomes through higher commodity prices in the early 2000s, then mining investment in recent years, and now through resources export volumes, as new capacity comes on line.

It has helped a great deal to have strong trade ties to the fastest growing economies in the world. Over past five years, growth in Australia's major trading partners has averaged 4.4% a year, while growth in the advanced economies averaged only 0.8% a year (Chart 4). Although growth in the advanced economies is expected to pick up in the coming five years, Australia's major trading partners are still expected to grow more quickly.

4. Australia's strongest ties are to fast-growing Asia

Source: ABS, IMF, HSBC

The increased reliance on China has prompted some observers to suggest that Australia's future is overly reliant on that economy. But without strong ties to China, Australia would not have fared as well as it did through the global financial crisis. It seems likely that the benefits of strong links to one of the world's fastest growing economies outweigh the costs of the risk of increased reliance on as single economy.

Australia is also a significant partner for China. Of the countries from which China imports, Australia is the fifth largest source of imports, which is a significant achievement for a small nation. Only the large economies of the US and Japan and neighbours Hong Kong and Korea have larger export exposures to China than Australia. Australia exports more to China than is exported by giant economies like Germany, Brazil, Russia, Indonesia and India. No other OECD economy has a larger export exposure to Asia than Australia and largest part of this is to China.

Asian role still increasing

A snapshot of Australia's current trade reveals that countries in Asia account for seven of Australia's major trading partners (eight if New Zealand is included) (Table 5). Three Asian economies alone – China, Japan and Korea – account for 54% of Australia's exports.

Commodities dominate these exports, led by iron ore, coal, LNG and gold. For iron ore, Australia is the world's largest exporter. Iron ore accounts for 19% of Australia's total exports and almost all of it is sent to China, Japan and Korea. The bulk of Australia's coal exports, which account for 13% of total exports, also go to these three economies.

5. Australia's top ten export markets

2013		Goods*	Services*	Total*	Share %
1)	China	95	7	102	31.9
2)	Japan	48	2	50	15.5
3)	Korea	20	2	21	6.7
4)	US	10	6	16	4.9
5)	India	10	2	11	3.6
6)	NZ	7	4	11	3.5
7)	Singapore	6	4	9	2.9
8)	Taiwan	7	1	8	2.5
9)	UK	4	4	8	2.5
10)	Malaysia	5	2	7	2.2
Total exports		263	55	319	76.2

Source: ABS. *Shown in AUDbn

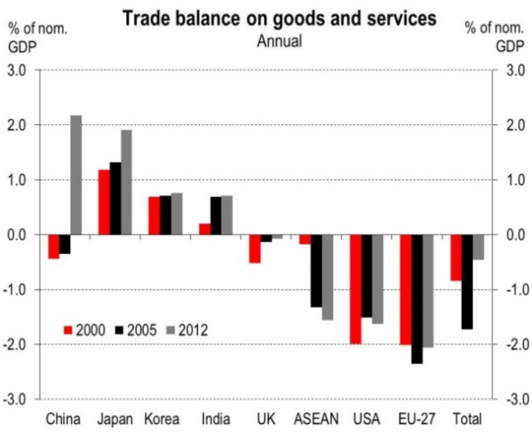
Of Australia's exports to **China**, 61% is iron ore and coal, with this share expected to rise further, as we discuss below. Australia does, however, export other things to China. Education exports to China have risen strongly in recent years such that they are now Australia's fourth largest export to China, behind iron ore, coal and gold and account for 4% of exports to China. Chinese tourist arrivals to Australia have ramped up strongly in recent years and China is also Australia's single largest market for wool and cotton.

Australia's exports to **Japan** are also dominated by hard commodities, with coal and iron ore accounting for 47% of total exports. Most of Australia's exports of LNG also go to Japan, at this stage, with LNG accounting for 30% of the total. Australia's fourth largest export to Japan is beef, which accounts for 3% of exports to Japan. From Japan's perspective, Australia is an important trading partner, supplying around two-thirds of Japan's coal and iron ore imports as well as a fifth of its LNG imports.

Australia's exports to **Korea** are also dominated by iron ore and coal, which account for 49% of exports to that country. Korea is also Australia's single largest market for sugar, taking 35% of exports, and is a significant market for Australian wheat and beef exports.

Australia's fourth largest export market is the **United States**, with business services and beef the largest exports to this market. The US is also a key source of Australia's imports of aircraft, travel and business services as well as motor vehicles. As a result, Australia runs a trade deficit with the US, as it does with Europe and the ASEAN economies (Chart 6). In contrast, Australia has significant trade surpluses with the largest Asian economies: China, Japan, Korea and India.

6. Australia has trade surpluses with the big Asian nations



Source: ABS

Australia's trade with **India** had been on a trend rise since the beginning of the century. Indeed, for a short time in 2010, India became Australia's third largest export market, overtaking Korea. This was, however, short-lived as growth in India slowed sharply in 2012 and 2013. It is now Australia's fifth largest export market. Coal and gold are Australia's most significant exports to India, together accounting for 54% of exports. Australia's third largest export to India, however, is education services, which account for 11% of Australia's exports to India.

Other trading partners play a smaller role. **New Zealand** is Australia's sixth largest export market, at 3.5% of exports. A significant share of trade with New Zealand is personal and business travel services. Australia also exports manufactured goods to New Zealand, particularly products used in construction.

Singapore comes in at seventh place, at 2.9% of exports. Australia's single largest export to Singapore is crude petroleum, although Australia then imports greater quantities of refined petroleum in return, leaving it with a trade deficit with Singapore. Business and transport services are also traded with Singapore.

Taiwan is Australia's eighth largest export market, at 2.5% of exports, with Australia's top exports to Taiwan being coal and iron ore, which account for 57% of exports.

Britain is the ninth largest export market, with tourism the single largest export at 23% of the total.

In tenth spot is **Malaysia**, to which Australia's major exports are crude petroleum and education services.

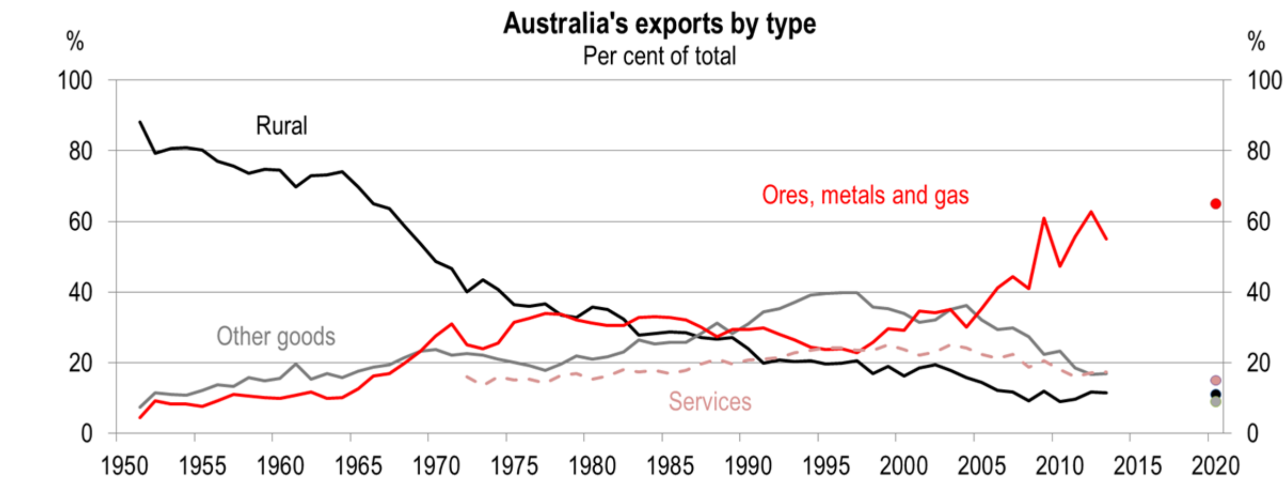
In sum, it is quite clear that commodities dominate the story and, given the recent resources investment boom, we expect them to rise further.

More resources supply yet

Australia's recent resources boom is just entering the production stage. Exports are expected to continue to ramp up for a number of years, as new capacity comes on line. The biggest ramp-up is expected in iron ore, coal and LNG exports over coming years. The forthcoming increase in LNG exports is particularly large, as the eight major LNG projects, which constituted over three-fifths of all of the investment in recent years, become productive.

This strong growth is expected to see resources exports rise as a share of Australia's total exports (Chart 7). Our estimates suggest that hard commodities and energy should rise from 57% of the value of exports in 2013 to 65% by 2020, although the projections of these shares are heavily dependent on the outlook for iron ore and coal prices. As LNG export prices are largely set in long-term contracts, projections of the value of these exports are more certain. LNG exports alone are expected to increase from around 5% of exports to 12% of exports by 2020.

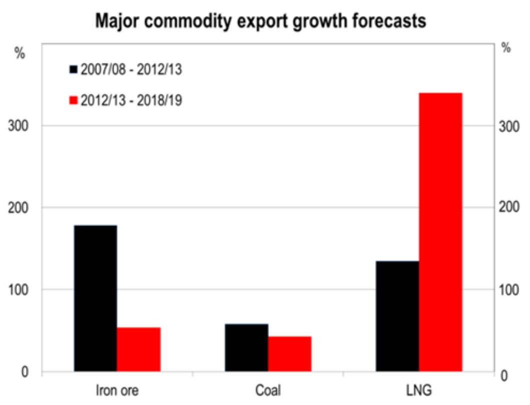
7. The mining investment boom is still driving a strong pick-up in resources exports



Source: ABS, RBA, HSBC estimates

The government's Bureau of Resources and Energy Economics is forecasting increases over the next six years in the value of exports of iron ore of +54%, coal of +41% and LNG of +330% (Chart 8). Iron ore exports are expected to rise from 527m tonnes in 2012-13 to 847m tonnes by 2018-19, and from AUD57bn to AUD88bn. Coal exports are expected to rise from 336m tonnes to 437m tonnes, from a value of AUD39bn to AUD55bn. LNG exports are expected to rise by from 24m tonnes to 79m tonnes and from AUD14bn to AUD60bn.

8. Strong resources export rise coming, particularly for LNG

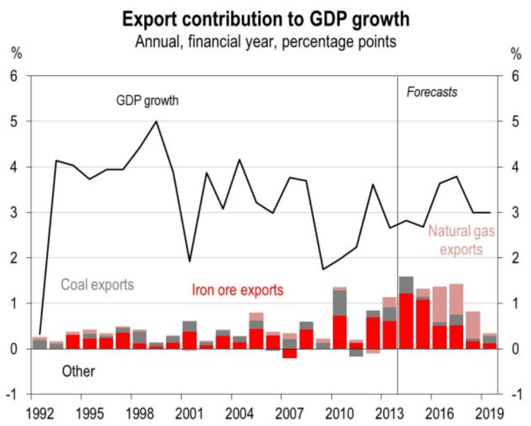


Source: BREE, HSBC

We expect Australia to become the largest exporter of LNG in the world, overtaking Qatar by 2020. Eight major LNG projects are currently under construction and the first of these is set to begin exporting from late 2015. These exports have been forward-sold on contract to China, Japan, Korea and India. For more details on Australia's LNG investment boom see Bloxham, P. et al (2013) '*Australia's growing role in Asian gas markets*', 26 September.

The ramp-up in resources exports over coming years is expected to be a key source of Australian GDP growth. Indeed, given the expected ramp-up in resources export volumes, we expect that exports could account for around two-fifths of real GDP growth over the next five years, up from an average of one-fifth over the past two decades (Chart 9).

9. Export volume growth to underpin GDP growth



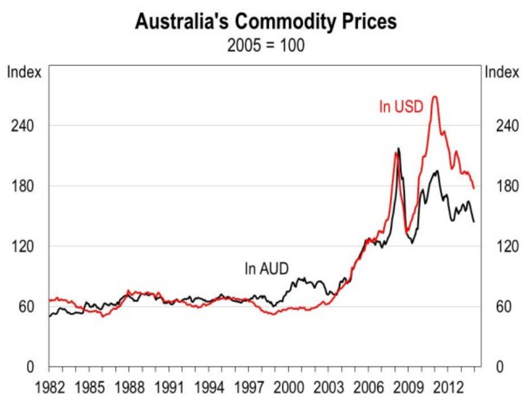
Source: ABS, BREE, HSBC estimates

Asian commodity demand

Strong and on-going demand for commodities is a part of the structural shift in global growth from West to East. As the Asian economies have developed, they have needed more commodities to grow. For the past decade, this story has been led by China. The urbanisation and industrialisation of China has required vast quantities of iron ore, coal and other metals to build housing and infrastructure.

We remain of the view that demand for commodities will remain strong and that commodity prices will remain high relative to the low levels they reached in the 1980s and 1990s (for more on this view see Bloxham, P. et al (2013) '*Global commodity prices: More super, less cycle*', 5 September). The price of the basket of Australia's commodities is currently 90% higher than it was at the turn of the century, in Australian dollar terms (Chart 10).

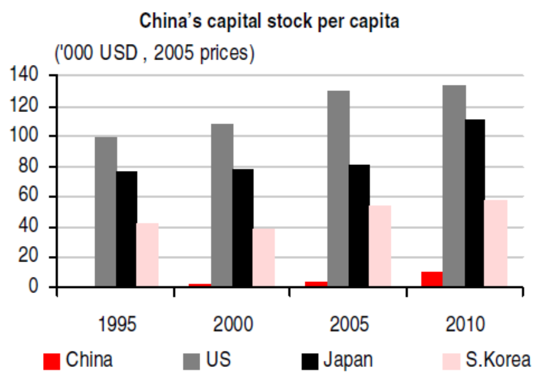
10. Commodity prices still high relative to 1980s and 1990s



Source: RBA

Our view on commodity prices partly reflects that we expect significantly more Asian infrastructure investment, including more investment in China. Indeed, despite high levels of investment over a run of years China still has a stock of capital that is significantly smaller than in comparable developed economies (Chart 11). HSBC's view is that China has a lot more infrastructure to build, which is expected to support demand for hard commodities. Our China economists believe that China is still investing too little, not too much (see Qu, H. (2014) '*China Economic Spotlight: Rebalancing – a dangerous obsession*', 25 June).

11. China has a low amount of capital per person

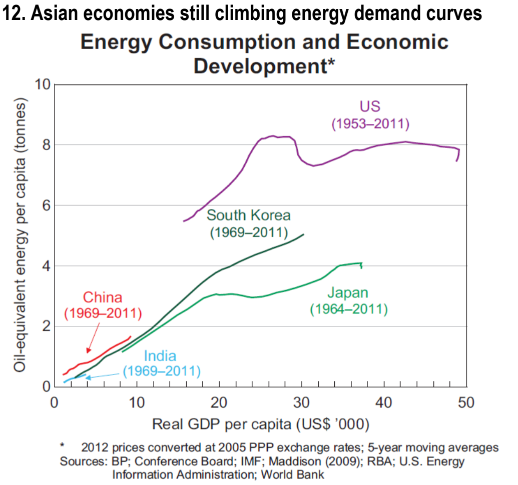


Source: CEIC, BEA, Japan's Cabinet Office, HSBC

Of course, China is not the only source of demand for Australia's commodities. Significant quantities of iron ore and coal are also exported to Japan, Korea and India, as we noted above. Given India's recent change of government and significant plans to boost infrastructure investment, there is strong potential for India to be a growing market for Australia's commodity exporters (for more on this see Bloxham, P. and Neumann, F. (2014) '*Commodities and India: If India lifts, commodity demand could too*', 28 May).

Australia's shift from metals towards greater energy production also reflects changing demands from Australia's trading partners. Energy consumption rises strongly as countries develop and China and India are still at low levels of per capita energy consumption relative to Japan and South Korea (Chart 12). We expect continued strong growth in demand for energy products, particularly for LNG. For more on this see: Man, R. and Chan, W. (2013) '*Powering Up: Raising the bar on energy in Asia*', 17 December.

12. Asian economies still climbing energy demand curves



Source: RBA

The Fukushima incident of March 2011 has also seen an increase in demand for LNG. As a result of the event, policymakers shut down all of Japan's nuclear plants, which previously accounted for around 30% of electricity production. Without these nuclear plants, Japan has shifted towards other sources of energy, including Australian thermal coal and LNG.

What if China slows?

Given Australia's high trade exposure to China, a key question is what would happen if China slowed more than expected. While HSBC's central view is that China's GDP will grow by 7.4% in2014 and by 7.7% in 2015, there are always risks. Clearly, there is a great deal of uncertainty about the likely impact of slower growth and, in particular, the speed of adjustment is important. Consider that China has already slowed from averaging annual growth of 10% to around 7.5%, and Australia has so far fared well.

In our view, the clearest impact on Australian resources exports would likely to be on commodity prices, rather than volumes. Export volumes are likely to be fairly well supported for the following reasons:

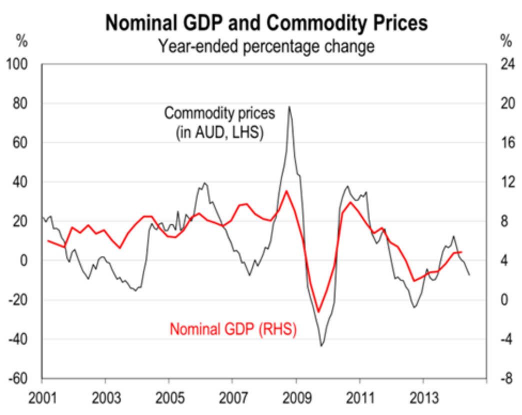
- For iron ore, Australia is the lowest cost producer, so other suppliers are more likely to cut production first. The larger Australian producers have costs at around USD35-45 a tonne, while the smaller players are around USD75 a tonne. These are well below the Chinese costs of USD90-100 a tonne.
- For LNG, almost all of the new capacity (91%) is forward-sold on long-term contracts. While there may be growing competition from the US and Canada, Australia is well ahead of these countries in building its LNG facilities, with local capacity set to start becoming productive from late 2015. Demand for this product is also likely to be highly income inelastic. Even if growth slows, it is unlikely to upset the trend move towards cleaner energy production.
- For coal, the story is less promising. A number coal mines projects in Australia operate at higher costs and the recent decline in prices has put pressure on their profitability. However, in many cases export volumes are expected to continue to rise as miners stand to lose more if they stop production than if they continue. In some cases, this is due to the high fixed cost of investment in new capacity and the rigid contractual arrangements for railway usage.

It is also worth noting that during the Asian financial crisis in 1997, Australia's resources were redirected from Asian markets to Western markets, mainly the United States. Weaker Chinese demand could see commodity exporters redirect their shipments to other markets.

On the likely impact of a fall in commodity prices on Australian incomes, much depends on the AUD. This is because Australia's commodity exports are almost all sold in USD terms. In the past, the AUD has acted as an international shock absorber, falling when commodity prices decrease and rising when they increase. For example, if commodity prices fall in USD terms and the AUD does not fall, this reduces Australia's local incomes, but if the AUD falls, the shock to Australian incomes is absorbed by the currency.

Clearly, the outlook for commodity prices is important for Australia as they can make a substantial difference to local income growth (Chart 13). As we noted above, we remain of the view that commodity prices will remain structurally high and, as we have discussed, there are a number of factors that could mitigate the impact of a fall in prices, not least the AUD. Nonetheless, risk to the commodity price outlook is a risk to Australian growth.

13. Commodity prices in AUD important for nominal growth



Source: ABS, RBA

Beyond resources exports

Although the resources export ramp-up is far from over, as we discussed above, Australia does need to consider what other opportunities will be on offer as Asia's economies continue to develop. Middle class incomes are expanding rapidly in Asia. HSBC expects that the global middle classes will increase by 1.3bn people by 2030, with most of this growth expected in emerging Asia. This wave of new consumers on Australia's doorstep should present trading opportunities beyond the mining sector.

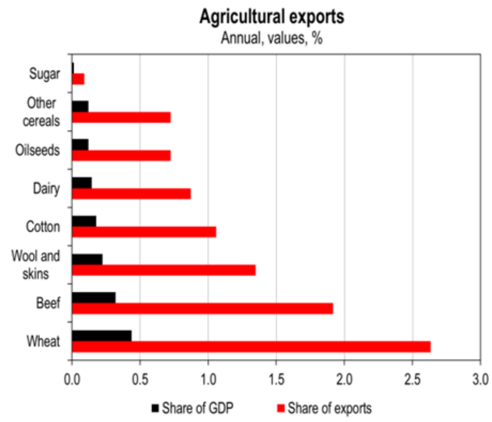
We expect rising middle class incomes in Asia to increase demand for high quality food, tourism, education and business services, presenting Australia with further trading opportunities.

Although commodity exports are important for Australia, around 40% of Australia's exports are outside of hard commodities and energy. Of this, rural exports account for 12%, manufactured goods for 10%, education services for 5%, tourism for 4%, and other services for the remaining 8%. No single export could be as important to Australia as resources exports in the foreseeable future, but there should, nonetheless, be opportunities in each of these areas.

Better food: From mining to dining

Although agriculture only accounts for 2% of GDP, much of Australia's rural product is exported: they account for 12% of exports. Indeed, Australia's small population and large land mass make it a large global exporter of agricultural products. Australia's largest rural exports are wheat, beef, wool, cotton and dairy products (Chart 14). Australia is the world's largest exporter of wool, the third largest exporter of beef, cotton and sugar, and the fourth largest exporter of wheat and dairy.

14. Wheat, beef, wool and cotton dominate rural exports



Source: ABS, DFAT

Many of Australia's agricultural exports already go to Asia. The largest markets for Australian wheat are Indonesia, Korea and China. For beef, Japan tops the list, followed by the US and Korea. Three-quarters of Australian produced wool and two-fifths of the cotton is exported to China. The leading destinations for Australia's dairy exports are Japan, Singapore and China (Table 15).

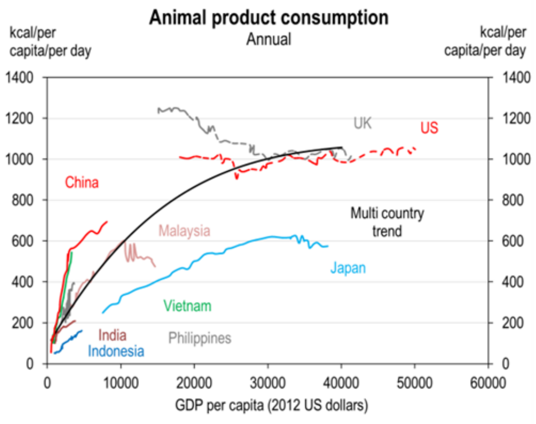
We expect further growth in demand for agricultural exports and for the greatest opportunities to be in exporting finer foods, such meat, dairy, sugar and edible oils. Historical patterns show that as countries get richer demand is strongest for these finer foods. In particular, demand for animal products rises substantially as countries develop, which should see demand for Australia's meat and dairy exports continue to rise (Chart 16). For more information on these global trends see Bloxham, P. et al (2014) '*Global agricultural commodities: Demand is shifting to the finer foods*', 18 March.

15. Australian exports and major markets

	Export values (2012-13, AUDbn)	Share of Australia's export values (%)	Global export rank*	Major export markets (Share of total in brackets)
Total commodities	**207.5**	**68.8**	-	-
Hard commodities	**171.2**	**56.7**	-	-
Iron ore	57.1	18.9	1 (38%)	China (71%), Japan (17%), Korea (10%)
Coking coal	22.4	7.4	1 (50%)	Japan (30%), India (23%), Korea (12)
Thermal coal	16.2	5.4	2 (17%)	Japan (47%), Korea (19%), China (13%)
Gold	15.3	5.1	4 (8%)	China (36%), UK (24%), India (19%)
LNG	14.3	4.7	3 (9%)	Japan (77%), China (17%), Korea (4%)
Oil	12.5	4.1	26 (1%)	China (22%), Singapore (17%), Korea (13%)
Copper	8.1	2.7	4 (4.6%)	China (27%), Japan (18%), India (16%)
Alumina	5.6	1.9	-	-
Aluminium	3.6	1.2	8 (3%)	Japan (31%), Korea (15%), Thailand (10%)
Other hard	16.1	5.3	-	-
Rural commodities	**36.3**	**12.0**	-	-
Wheat	6.8	2.3	4 (12%)	Indonesia (18%), Korea (10%), China (8%)
Beef and veal	5.1	1.7	3 (17%)	Japan (34%), US (22%), Korea (13%)
Wool and Skins	3.3	1.1	1 (63%)	China (75%), India (6%), Italy (4%)
Cotton	2.7	0.9	3 (11%)	China (60%), Indonesia (10%), Thailand (7%)
Dairy	2.1	0.7	4 (7%)	Japan (23%), Singapore (9%), China (7%)
Coarse grains**	2.1	0.7	7 (4%)	Saudi (27%), China (26%), Japan (19%)
Oilseeds***	2.0	0.7	7 (2.5%)	Netherlands (43%), Belgium (28%)
Sugar	1.4	0.5	3 (6%)	Korea (35%), Indonesia. (28%), Japan (14%)
Other rural	10.8	3.6	-	-
Beverages (incl. wine)	2.1	0.7	-	-
Manufactures	**31.1**	**10.3**	-	NZ (12.5%), US (11.2%), China (10.3%)
Services	**52.8**	**17.5**	-	China (12.5%), USA (10.8%), UK (7.2%)

Source: ABS; ABARES, USDA, DFAT, Dairy Australia, EIA, USGS, UN
*Brackets show % of global exports. **Barley, corn, sorghum, oats and maize, barley only for major export markets. ***Canola, soybeans and sunflower seeds.

16. Animal product consumption set to rise further

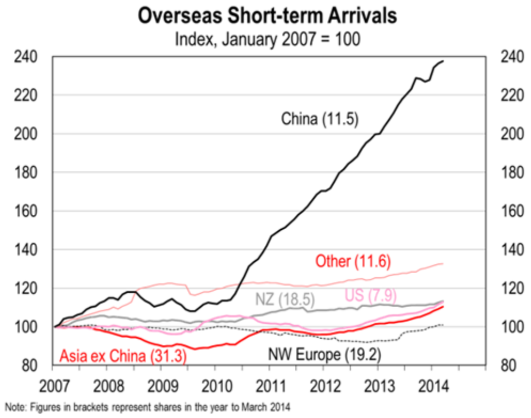


Source: FAO, Conference Board; HSBC

Tourism: Chinese arrivals rising

Tourist arrivals from Asia have ramped up in recent years, with particularly strong growth in arrivals from China (Chart 17). Indeed, Chinese arrivals have increased by 110% over the past four years, despite the high level of the Australian dollar through that period.

17. Chinese visitors numbers to Australia have taken off

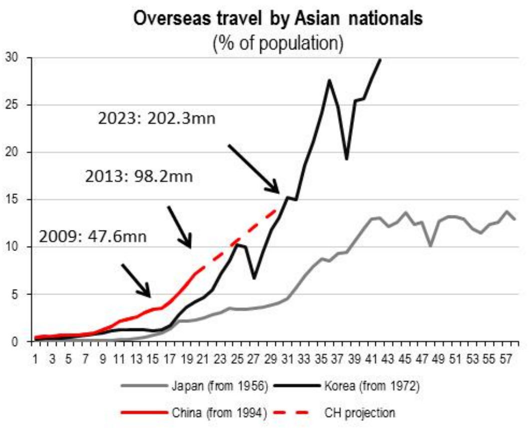


Source: ABS

The ramp-up in Chinese tourist arrivals is reminiscent of the pick-up in Japanese tourists visiting Australia in the late 1980s. The boom in Japanese tourist numbers in the late 1980s transformed many of Australia's key tourist destinations. At the time, this saw significant investment in hotels and resorts to meet these new demands. Queensland was a key beneficiary, with places like Cairns and the Gold Coast benefitting from new tourist inflows and adjusting to better meet this demand. For example, the late 1980s saw a proliferation of local signage in both English and Japanese in these locations.

Of course, the rise of the Chinese tourist is not just a story for Australia, it is happening across the world. Importantly though, it is also happening in Australia. As pointed out in recent work by my colleague, Fred Neumann, there are lessons to be learned about the Chinese tourism story from the rise in Japanese and Korean tourists in second half of the twentieth century (Chart 18). Chinese outbound tourist numbers have risen from 10m in 2000 to almost 100m last year. Using Japan and Korea as historical templates, HSBC projects that outbound Chinese tourist numbers will rise from 98m people in 2013 to 202m over the next ten years. See Neumann, F. (2014) '*Chart of the week: Here come the Chinese*', 27 June.

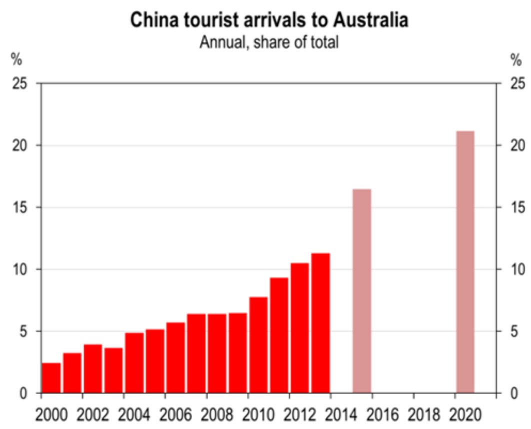
18. Chinese tourist numbers expected to continue rising



Source: CEIC, HSBC

If Australia continues to attract its current share of these visitors and the more traditional tourism markets grow at their average rate, we forecast that China will account for 1.8m visitors to Australia by 2020, up from 720,000 last year. This would see Chinese arrivals overtake New Zealand to be the single largest source of tourist numbers and account for 21% of the total (Chart 19).

19. Chinese tourists to Australia set to rise



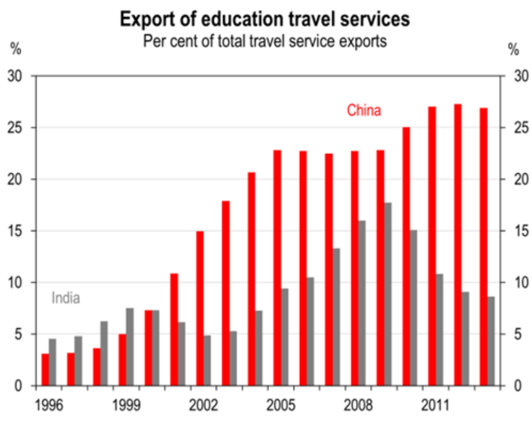
Source: ABS, HSBC

Education services: An Asian story

Education is already an important source of export earnings for Australia, being Australia's third largest export earner (5% of total), behind iron ore and coal and slightly ahead of LNG and gold exports.

Around four-fifths of foreign students come from Asia, with China and India the two largest export markets (Chart 20). Student numbers had declined between 2009 and 2012, reflecting a range of factors, including the high Australian dollar, decisions by the previous government to cut back on student visa issuance, and reduced enrolments, particularly of Indian students, due to violent incidents in 2010. However, enrolments picked up in 2013, and we expect further growth in coming years.

20. China and India are already key for education exports



Source: ABS

Business services: Asia needs them

Australia's business services sector should also get a boost from Asia's on-going development. As emerging Asia demands more services such as finance, accounting, health, marketing and consulting services, there should be opportunities for Australia. Professional, technical, financial and other business services already account for 3% of Australia's exports. Business travel services account for 1% of Australia's exports.

Growing population and financial linkages with Asia, which we discuss in the following two chapters, should help to facilitate opportunities for greater exports of business and financial services. Australia is well placed to benefit from the opening up of the Asian financial system. Further liberalisation of the Chinese financial system should give Australian businesses opportunities to attract offshore investment for expansion as well as giving local investors options to diversify offshore.

Manufacturing: Challenging space

It seems likely that Australia's exports of manufactured goods will fall in coming years, although it is worth keeping in mind that they only account for 10% of total exports. Manufactured exports have been a declining share of total exports since the early 2000s, when they accounted for 20%. Transport equipment currently accounts for 16% of manufactured exports and the recent announcement of plans for Holden, Toyota and Mitsubishi to cease local production by 2017, will likely see a fall in these exports. Other areas of manufacturing, such as wine production (0.7% of total exports) and higher valued added goods are expected to see continued medium-term demand, particularly from Asia. These high-value added areas of manufacturing are where Australia is likely to see expansion although, as we point out in the final chapter, policymakers and businesses need to focus on improving productivity and competitiveness to make the best of these opportunities.

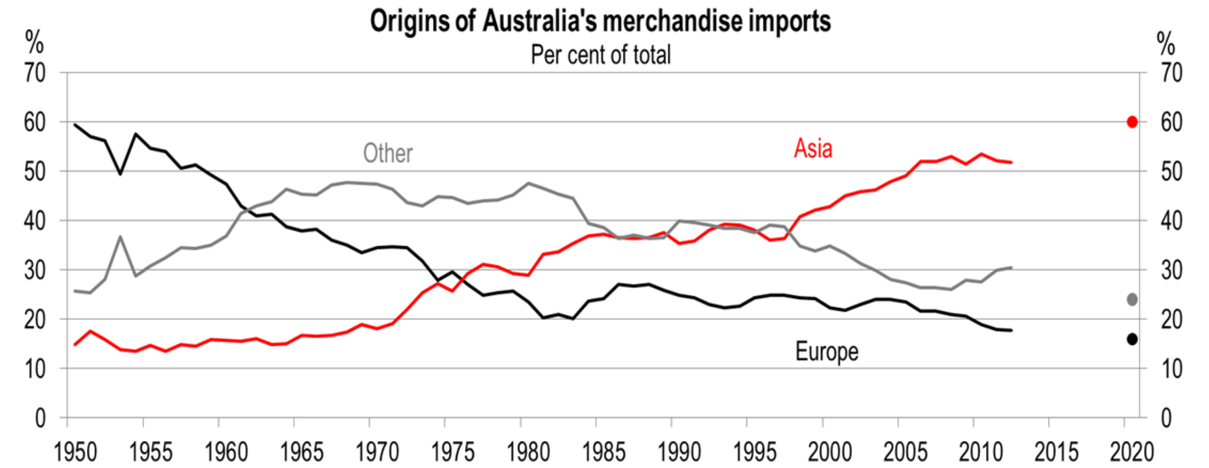
Imports are Asia-dominated

Australian imports have also been dominated by Asia since the turn of the century, as manufacturing has increasingly shifted to Asia and Australia's main import needs are manufactured goods. Falling manufactured goods prices, particularly from Asia, also benefited Australia substantially. Imports from Asia have risen from 43% to the total in 2000 to 54% of total imports in 2010, and we expect this share to rise to 60% by 2020 (Chart 21).

Australia's imports are much more evenly spread across a large group of countries than its export markets. This partly reflects that most of what Australia imports are manufactured goods, which come from a diverse range of markets, while most of what is exported is bulk commodities.

China is the single largest provider of imports into Australia with manufactured goods dominating that trade (Table 22). Australia's largest imports from China are telecommunications and computer equipment which account for 20% of imports, while clothing accounts for 9% and furniture for 4%.

21. Imports from Asia have also been rising



Source: ABS, RBA, HSBC estimates

22. Australia's top ten import markets

2013		Goods*	Services*	Total*	Share %
1)	China	47	2	49	15.0
2)	US	27	12	39	11.9
3)	Japan	19	2	21	6.5
4)	Singapore	13	5	18	5.4
5)	Thailand	11	2	14	4.2
6)	Germany	11	2	13	4.0
7)	UK	6	6	12	3.7
8)	Malaysia	9	1	11	3.3
9)	Korea	10	1	11	3.3
10)	NZ	7	3	11	3.2
Total exports		259	70	329	60.5

Source: ABS. *Shown in AUDbn

The **United States** is the second largest provider of Australian imports, with services accounting for 32% of imports. Travel constitutes around 10% of imports, while professional and business services are 7%. Australia's most significant goods imports from the US are motor vehicles and engineering equipment.

Imports from **Japan** are dominated by motor vehicles, which account for 38% of imports from that country.

Singapore is Australia's main source of refined petroleum with this product accounting for 49% of all imports. Transport services account for 15% of Australia's imports from Singapore.

Thailand exports a significant number of motor vehicles to Australia with these accounting for 34% of imports from that country.

Trade ties to get stronger

Australia's trade ties to Asia are strong and growing. By 2020, we expect that 80% of Australia's exports will go to Asia, up from 73% now and only 50% in 2000. China is expected to continue to be Australia's fastest growing trading partner, although other Asian countries should also see strengthening ties.

Trade ties should also help support and be supported by growing population and financial links to Asia – the topics of the next two chapters.

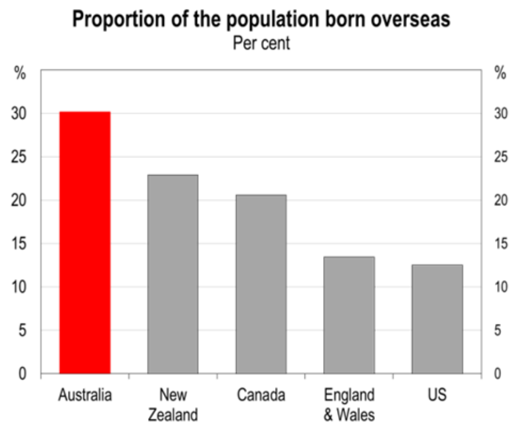
Australia's population is becoming Asia-integrated

- Australia's population is one of the most 'foreign', with 28% of the population born outside of the country
- Migration flows have shifted to being dominated by flows from Asia, away from the historically strong links with Europe and the UK
- Strong Asian population linkages help facilitate increased trade, particularly of services and greater financial connectedness

Large foreign-born population

One of the unique features of Australia is its exceptionally large foreign-born population. With 28% of the population born outside of the country, Australia's population is significantly more 'foreign' than similar countries with open migration programmes (Chart 23).

23. Australia's foreign-born population is high



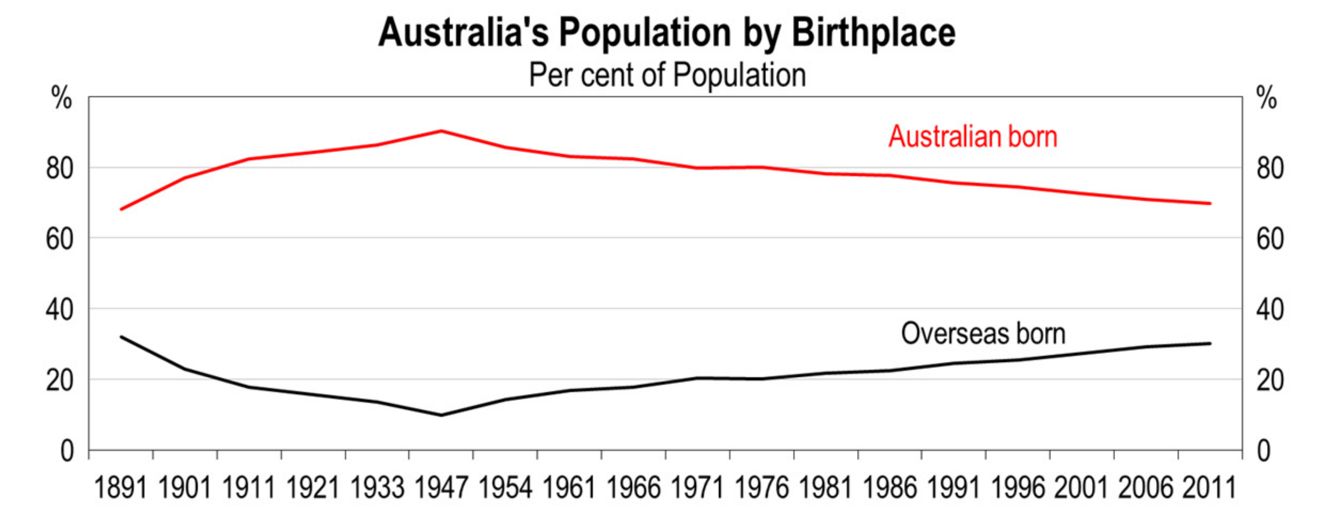
Source: ABS

The number of foreign-born Australians is even larger if we step back a generation. Census data for Australia suggest that more than half of the population was either born overseas or have parents that were born overseas.

This large foreign-born population was, however, not always the case. The restrictions on immigration imposed in the early 20th century and the 'White Australia' policy, which was not fully dismantled until 1973, saw a significant fall in migration to Australia in the first half of the 20th century, with the foreign-born population troughing at 10% of the population in 1947 (Chart 24). Pro-migration policy since then has seen the overseas-born proportion of the population rise strongly over the post-WW II period.

Migration flows have been particularly strong in the past eight years and have been the key contributor to population growth (Chart 25). In the past decade, 2m new migrants have moved to Australia and account for 10% of the population. Over that period, population growth has averaged 1.4% y-o-y, compared to an average of +0.7% y-o-y amongst the

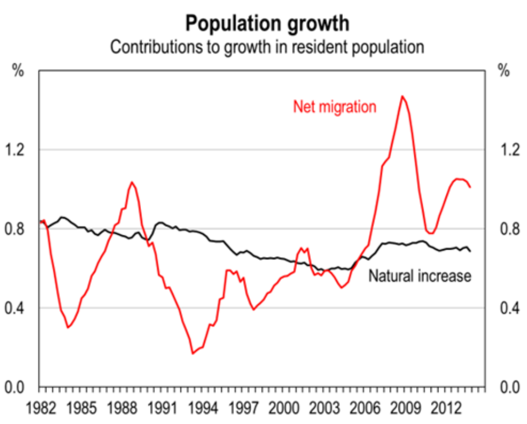
24. The share of Australia's population born overseas has been rising strongly throughout the post-WW II period



Source: ABS

OECD economies. Strong migration flows have therefore been a key driver of GDP growth in Australia over this period. Population growth over the past five years has been the fastest in the past three decades.

25. Strong population growth has been driven by migration



Source: ABS

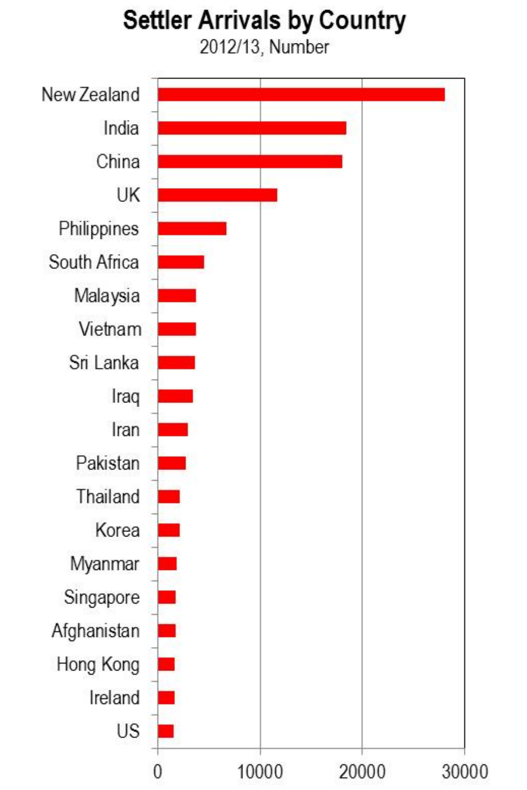
Most migrants now from Asia

Historical ties mean that the bulk of Australia's population has ties to Britain and Europe. But the population that was born in Asia is rising. Indeed, of the 5m people in Australia that were born overseas, around 2m of them are from an Asian country. In line with these numbers, government estimates suggest that 1 in 10 Australian residents claim to identify with an Asian ancestry and the census reports that there are more speakers of Mandarin in Australia than Italian or Greek.

The source of new migrants has been on a long pivot towards Asia. Migrants from Asia have been greater than from elsewhere since the mid-1980s. More recently, China and India have become key sources of migrants to Australia (Chart 26).

China overtook Britain as the single largest source of migrants to Australia in 2010-11 and then India overtook China to be the single largest source of migrants (excluding New Zealand, for which there is greater freedom of movement).

26. New flow of migrants increasingly from Asia



Source: ABS

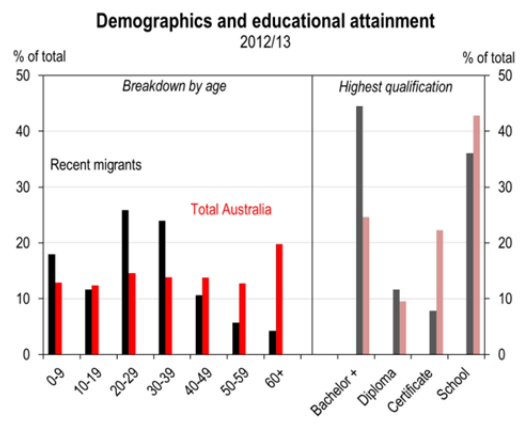
Boosts supply and demand

Migration boosts the supply capacity of an economy, as there are more workers available, and demand, as there are also more consumers. Strong migration has helped Australia's economy continue to grow through the global financial crisis, by continuing to support demand. Indeed, while Australia's overall GDP grew in 2009, following the failure of Lehman Brothers, per capita GDP declined, much as it did in most advanced economies. Without strong migration flows at the time, Australia may not have traversed that period without a technical recession, as it did.

Faster population growth, either through increased natural birth rates or migration can also help to deal with the challenges of an aging population, which clearly reduces the supply of labour in an economy. On average, new migrants to Australia tend to be ten years younger than the extant population and they also tend to have a higher level of education. In 2012-13, 74% of migrants were aged between 15 and 65, compared to 67% of the extant population (Chart 27).

Data from 2010 show that 45% of recent migrants had a bachelor degree or above, compared with 25% across the country as whole. A more highly educated migrant population is likely to reflect the impact of Australia's skilled visa programme, which allows the government to vary the types of migrants that arrive based on skills that are in most demand in Australia. Australia's education exports are also likely to be a driver of more qualified migrants as foreign students have a high propensity to seek citizenship.

27. Migrants are generally younger and better educated



Source: Department of Immigration and Border Protection, ABS

Migration strengthens ties

Strong migration flows also strengthen ties between economies in other ways. For example, they can assist the flow of technology and innovation across borders. The US has long benefited from having what many consider are the best universities in the world because they attract the best students, many of whom choose to stay in the US, which boosts their human capital. Migrant flows can also strength trade benefits as migrants maintain links to their home country. Financial links are also enhanced as migrants bring capital with them.

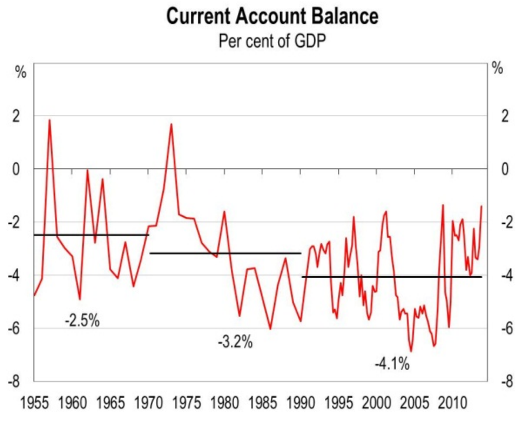
Financial linkages to Asia small, but growing

- Australia's financial ties are still mainly to Western markets, with 56% of FDI and 57% of ODI with the US and Europe
- To many Western investors, Australia is a platform for exposure to Asia's growth story, given strong trade and population ties
- As Asian financial markets deepen, particularly in China, Australia is set to see greater direct Asian financial connections

Reliant on foreign capital

Australia has had a current account deficit and thus a reliance on net foreign capital inflows for most of its history. Indeed, Australia has had a current account deficit for 56 of the past 58 years and a longer view of history reveals deficits in almost every decade since the 1860s (Chart 28).

28. Australia has had a persistent reliance on foreign funds



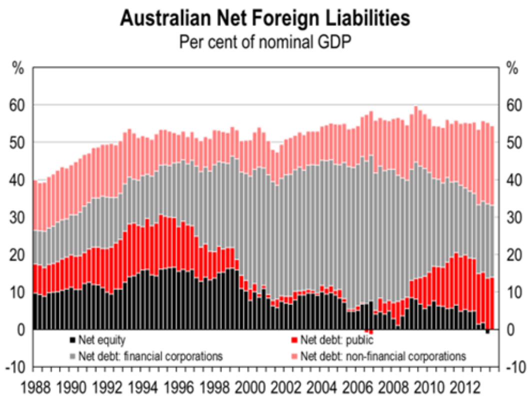
Source: ABS

Although some observers suggest that this means Australia is not saving enough, international comparison reveal that Australian national saving is about average amongst the advanced nations (at 24% of GDP), while the investment rate is high, at 27% of GDP. So Australia's current account deficit appears to be due to high investment, not low saving.

In recent years, much of that investment has been in new capacity to meet Asian demand for iron ore, coal and liquefied natural gas, as discussed above. Australia's persistent current account deficit may therefore be due to the fact that Australia only has a small population, but a large mineral wealth, so it needs to borrow from abroad to fund more investment than its population could do with its own saving. Assuming this is the right capital to build and it eventually yields a stream of income, it seems like a reasonable strategy – indeed, it could be close to the optimal strategy.

A consequence of a persistent current account deficit has been sustained elevated levels of net foreign liabilities. Net foreign liabilities account for around 55% of GDP and have been fairly steady at around these levels for the past two decades (Chart 29).

29. Australia's net foreign liabilities are high but stable



Source: ABS

There have, however, been shifts in the types of net foreign liabilities, reflecting changes in the drivers of growth in Australia in recent years.

Bank funding played a large role in foreign flows between 1995 and 2007, as local banks borrowed from offshore to help fund a housing boom, with capital inflows mostly coming from Western markets. The global financial crisis, slower credit growth and a shift by banks to domestic sources of funding saw a sharp decline in bank flows since 2008 (the grey bars in Chart 29).

The mining boom then played a growing role in net foreign liabilities, with non-financial corporate foreign liabilities doubling in share since 1997 (the pink bars in Chart 29). Since the global financial crisis, the largest international capital flows have been investors in Australia's resources industry, which is four-fifths foreign-owned.

The largest resources projects have been funded by multi-nationals such as: Chevron, Shell, BP, Exxon Mobil, Inpex, Conoco Phillips, Sinopec, BG Group, Total, Petronas, Rio Tinto, as well as Australian multinationals such as BHP Billiton.

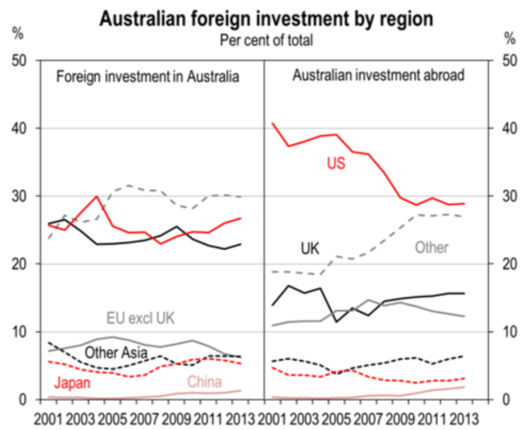
Another contributor to the shifting composition of Australia's net foreign liabilities has been significant loosening of fiscal policy after 2007, to support growth. As a consequence, the government's offshore borrowing has risen strongly since 2007 (the red bars in Chart 29).

Western linkages dominate

Although Asia dominates Australia's trade and population flows, as discussed above, direct financial ties to Asia are still fairly limited.

Most of Australia's offshore investment still goes to the UK, the US and European markets (57% of total), while the same countries account for the bulk of outstanding foreign investment in Australia (Chart 30). Cultural and historical ties as well as more developed and deeper Western capital markets help to explain these strong links to the West. Less developed and more restricted Asian financial markets may help to explain smaller links. It is also likely to reflect that capital, which seeks to come to Australia from Asia, may first travel through Western markets.

30. Most of Australia financial links are with the West



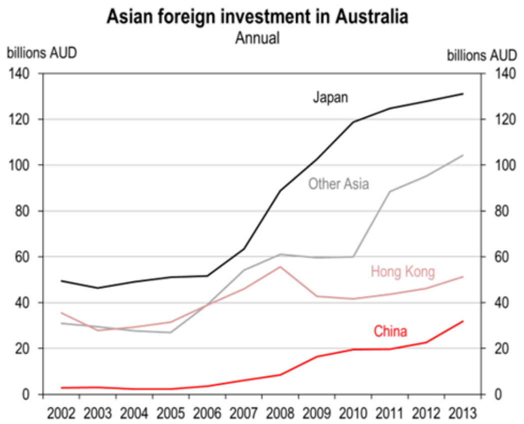
Source: ABS

For many Western investors, Australia represents a platform to get exposure to the fast-growing Asian nations. In recent years, this has largely been global resources companies investing in capacity to produce iron, coal, LNG and other commodities. Reflecting changing patterns of demand in Asia, this could start to be driven by investment in Australia's agricultural and services industries. There is growing international interest in investing in Australia's local industries, such as the retail sector. This reflects both Australia's recent economic success and its increasing ties to Asia, which are, of course, related.

Asia's small, but growing role

Australia's financial links to Asia are still fairly small, but are growing quickly. Asia accounts for only 13% of total foreign investment in Australia. Japan is the single largest investor, accounting for 5% of total foreign investment (Chart 31). Investment from Japan is evenly split between large holdings of Australia's government debt and other types of investment in Australia, including foreign direct investment.

31. Asian foreign investment in Australia has been rising

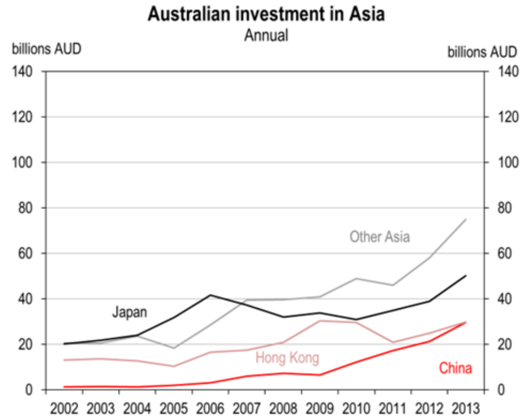


Source: ABS

China accounts for only 1.3% of total foreign investment in Australia, although this has risen from 0.3% ten years ago. Together, China and Hong Kong – through which some of the mainland investment is funnelled – account for 3.4% of foreign investment in Australia.

On the other side of the balance sheet, Australia's investment in Asia is even lower, accounting for only 11% of total investment abroad (Chart 32). Although Australia has significant funds to invest, particularly in terms of its superannuation savings of around AUD1.8trn, little of this finds its way into Asian markets, at this stage.

32. Australian investment in Asia is still low



Source: ABS

Low capital account linkages to Asia reflect a number of factors, including historical and cultural ties. The still evolving nature of financial markets in much of Asia, especially outside of Japan, is a factor that has held back foreign investment flows. Capital controls in the Chinese market have been a constraint on the free flow of investment. Financial restrictions are also somewhat reinforcing, discouraging the development of liquid markets that allow the efficient hedging of financial risks and then further discourage investment flows.

However, much of this is changing as Asia's financial system develops.

Financial opportunities

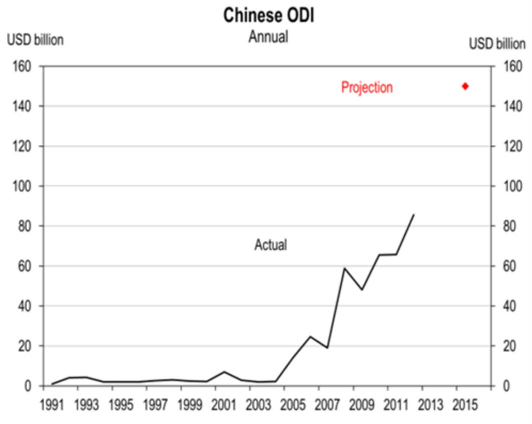
Asia's growth prospects and the significant amount of financial development that is yet to occur should offer Australia opportunities.

Drawing on Asian savings

Asia has a substantial pool of savings looking for high yielding assets. Demand for Australian assets has already been strong, with around 70% of all Australian commonwealth government bonds held by offshore investors. But the lack of depth of the local corporate bond market and almost non-existent infrastructure bond market make broader investment in Australian debt more challenging. Australian infrastructure could have a lot to offer in this area.

The opportunities to make use of Asian savings are substantial, particularly from China. China is seeking to rapidly open up its financial system and part of the plan is to boost overseas direct investment significantly. Overseas direct investment has been a priority for the Chinese authorities and has increased substantially in recent years (Chart 33). China's Ministry of Commerce is forecasting a doubling of China's total overseas direct investment between 2012 and 2015.

33. Chinese overseas direct investment is ramping up

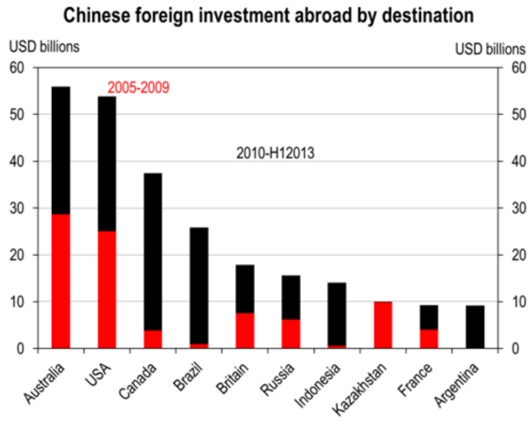


Source: CEIC, Ministry of Commerce projection

China has also recently set up the Shanghai free trade zone. This zone is designed to help facilitate further opening and deepening of Chinese financial markets by providing a testing ground for financial reforms. In particular, the zone has preferential treatment for certain forms of foreign investment. This is another step along the way to eventual full capital account convertibility.

Although overall Chinese overseas direct investment has been small, Australia has already played a significant role in its expansion. Data on large foreign investment deals from the Heritage Foundation show that Chinese overseas investment into Australia total USD55.9bn between 2005 and 1H2013, which is more than any other country over this period (Chart 34).

34. Australia is a key destination of previous Chinese ODI



Source: Heritage Foundation

Australian investment in Asia

Australia's superannuation system represents the world's fourth largest pool of pension savings, despite the fact that Australia is only the world's 12th largest economy. Much of this money is already invested abroad for diversification reasons and Asia could increasingly offer a home for these funds.

Stronger ties to the region could support a rise in Australia's exports of financial services to Asia and increased involvement in Asia's financial development. For Australian businesses, this could involve Australian funds managers managing more foreign capital, as discussed above. It could also involve banks doing more transactional banking in the region or local institutions managing more offshore financial activity from Australia.

Role of the renminbi

With China's role in Australia's trade expected to grow we expect an increasing role for the renminbi (RMB). Indeed, it is somewhat surprising how small a role the RMB plays in Australia's trade settlement. Data published by the ABS in June 2012 suggest that the value of Australia's goods trade that was settled in currencies other than the USD, AUD, NZD, GBP and yen was around 1% of all trade. This is surprisingly small, as even at that time 20% of Australia's trade was with China. We expect an increasing role for the RMB in Australia's trade and financial market activities.

Current limited usage of RMB in Australian trade settlement may reflect that Australia's trade is dominated by resources and almost all of these commodities trade in markets denominated in USD. But moves are afoot amongst commodity traders to shift towards greater usage of the RMB, particularly given that China is largest buyer of many commodities.

The role of the RMB in China's own trade is growing rapidly. Estimates suggest that 15% of China's trade is currently settled in RMB, up from near 3% in 2010. HSBC estimates that by 30% of China's trade will be settled in RMB by 2015 (see Qu, Hongbin et al (2014) '*The rise of the redback III: The world's next reserve currency*', 19 March.)

For Australian exporters and importers, independent surveys suggest there may be advantages of settlement in RMB. In a survey conducted by the RBA in 2013, there were three key advantages listed for settlement in RMB. First, there was an improved ability to negotiate with Chinese firms, partly because trading in the Chinese currency removed foreign exchange risk. Second, there was a recognition that Chinese companies may soon start to insist on increased RMB trade settlement. Third, using the RMB could improve the local firms' ability to hedge their own foreign currency exposure.

The RBA has bolstered Australia's financial infrastructure for dealing with increased usage of the RMB, by setting up a swap line agreement with the People's Bank of China in March 2012. The agreement allows the RBA to access up to CNY200bn (AUD30bn) of RMB in the event that the swap facility was activated. All Australian authorised deposit-taking institutions could access this facility if needed, at a cost, which would ensure sufficient RMB liquidity if it were needed.

In terms of financial transactions, RMB still plays a small role in Australian foreign transactions, in line with the small but growing role of direct financial flows between the Australian and Asian nations. This is likely to grow. Again, the RBA is playing a role, with its decision to gradually accumulate RMB equivalent to 5% of Australia's total foreign reserves. In April 2013, Australia also helped to strengthen ties with China by signing an agreement allowing the AUD to be one of only a handful of currencies that could be directly traded with RMB in the Chinese on-shore market.

Asian financial ties set to grow

Australia's strongest financial links remain to Western nations, with the US and the UK leading the way. This reflects historical and cultural ties as well as more limited financial market development in Asia. It also reflects strong demand for Australian assets by Western investors, partly because of Australia's recent economic success and but also because many Western investors see Australia as platform for exposure to Asia's growth story.

Although direct financial connections between Australia and Asia are fairly small, they are growing. Given already strong trade and population links, these financial flows are expected to increase in coming years. There are, however, more things that policymakers can do to support these growing connections – a topic we take up next.

Taking advantage of Asian opportunities

- Strong trade and population ties to the fast-growing Asian economies leave Australia well positioned
- Policymakers should continue to encourage greater exposure to these fast-growing economies through reform that makes the economy more open and flexible to trade and financial flows
- Local businesses should continue to seek to access to significant markets for their products in Asia

Policymaker's role

Making the most of these opportunities requires good policy. Australia has a comparative advantage in production of hard commodities and energy, but it is less clear that it has an advantage in exporting services or agricultural products. Policymakers and businesses have roles to play in improving Australia's productivity and competitiveness to best take advantage of the opportunities Asian growth offers.

Specifically, policymakers can play a role by reducing trade barriers to help support access to foreign markets, providing sufficient infrastructure, lowering barriers to entry, reducing cumbersome regulations, encouraging innovation, and helping support the development of capital markets to fund new activity.

Businesses also have a critical role to play as new opportunities are usually exploited by businesses. Most productivity-enhancing changes and innovations also typically occur at the firm-level, putting a great deal of onus on businesses to find ways to become more productive and competitive.

Trade policy

The most significant opening up of Australia's economy to international trade came in the 1980s and 1990s with substantial reductions in tariffs and other trade barriers. Average duties on trade with Australia fell from around 25% in 1985 to under 10% by the mid-2000s.

FTAs and multilateral agreements

There has been progress in bilateral trade agreements since then, although there has been only limited progress on multi-lateral arrangements. Indeed, Australia has free trade agreements with a most of its major trading partners, although it is still in negotiation with its largest trading partner, China.

Recent months have seen the new government sign free trade agreements with Australia's second and third largest export markets, Japan and Korea.

These agreements explicitly seek to support the expansion of Australia's trade in agricultural products and services in these two markets. In both agreements, tariffs on Australian exports of a range of agricultural products will be reduced and Australian service providers are to be given equal access to the local markets as other preferred trading partners. In exchange, Australian policymakers have lifted screening thresholds on Japanese and Korean investment in Australia amongst other things.

Australia has similar bilateral arrangements with Malaysia, Singapore, Thailand and the United States. Australia has almost no barriers to trade with New Zealand (see Table 35 for details) and a low barrier free trade agreement with Chile (currently only 0.3% of Australia's total trade).

Negotiations on bilateral free trade agreements with China, India, Indonesia and some of the Gulf states are currently underway. Negotiations with China are in their twentieth round, having begun in 2005. The current government is seeking to finalise a free trade agreement with China by the end of 2014.

Australia is a signatory to the WTO and involved in negotiations for a number of multi-lateral trade agreements. It already has a multi-lateral agreement with the ASEAN economies and New Zealand, which has been in effect since January 2012. Australia is also part of the WTO's Trade in Services Agreement and the Trans-Pacific Partnership, as well as negotiating a multi-lateral arrangement with the Pacific island nations.

Middling performance

Despite these trade arrangements there remains room for improvement. The World Economic Forums' Global Enabling Trade Report, published in 2014, suggests Australia is ranked between 15th and 24th of 138 countries on most of the seven 'pillars' of trade enablement. However, Australia does particularly poorly on 'foreign market access', with a ranking of 134th (Table 36). Australia also does poorly on the sub-categories of ease of compliance with government regulations (118th) and ease of hiring foreign labour (125th).

Table 36. Enabling trade index for Australia in 2014

Indicator/Pillar	Australia's rank*
1) Domestic market access	18
2) Foreign market access	134
3) Efficiency/transparency of border admin	22
4) Availability/quality of transport infrastructure	24
5) Availability/quality of transport services	20
6) Availability/use of ICTs	15
7) Operating environment	19

Source: World Trade Organisation. *Of 138 countries

The report lists the top five barriers to exporters as: identifying potential markets and buyers; high costs of international transport; access to imported inputs at competitive prices; tariff barriers abroad; and, burdensome procedures at foreign borders. For importers, the number one problematic factor is listed as burdensome import procedures. Not all of these challenges are easily remedied, but the local administrative burden should be addressed and policymakers should seek to improve Australia's access to foreign markets.

Table 35. Australia's free trade agreements

FTAs	Date in effect or signed	Countries involved	Main features of agreement
Signed and in effect			
1) ASEAN-Australia-New Zealand	January 2012	Brunei, Myanmar, Cambodia, Indonesia, Laos, Malaysia, Philippines, Singapore, Thailand, Vietnam	Tariff reduction; regional rules of origin; investor protection; economic cooperation projects.
2) Australia-Chile FTA	March 2009	Chile	Elimination of tariffs by 2015; national treatment for AU goods; liberal services and investment regimes; IP protection.
3) Australia-NZ Closer Economic Relations	1983	New Zealand	No tariffs or trade restrictions; minimised market distortion measures; food and professional qualification harmonisation.
4) Australia-United States	January 2005	United States	Eliminated two-thirds of agricultural tariffs with all to go by 2022; all trade duty free from 2015; access to the US for AU services suppliers; access to US government procurement market; measures to promote two-way investment.
5) Malaysia-Australia	January 2013	Malaysia	Elimination or reductions of tariffs on milk, autos, some manufactured goods, wine, iron and rice; AU right to majority ownership of Malaysian service firms in education, finance, telecommunications and professional services; greater access to Malaysian visas.
6) Singapore-Australia	July 2003	Singapore	Elimination of all tariffs; reduced restrictions on number of banking licences and financial services firms; better recognition of law degrees and joint ventures of law firms; easing of Singaporean residency requirements for Australian business people; paperless trading agreement.
7) Thailand-Australia	January 2005	Thailand	Elimination of all tariffs on Australian imports into Thailand by 2015 (except dairy); improved access to Thai services market; permitting majority ownership by Australian firms across selected industries; Improved investor protection; improved access to Thai visas for Australian business people.
Signed but not yet in force			
8) Korea-Australia	Signed April 2014	Korea	Eliminate tariffs on Korean imports of sugar, wheat and wine; beef tariffs reduced over 15 years from current 40%; dairy quotas and tariffs to be gradually eliminated; tariffs on 88% of Australia's exports to Korea of manufactures, resources and energy to be eliminated with remaining phased out over 10 years; same treatment for Australian service providers as for the US and Europe; raised threshold for investment in Australia from AUD248bn to AUD1.078bn for non-sensitive investments.
9) Japan-Australia Economic Partnership	Signed July 2014	Japan	Elimination of duties for 97% of Australia's exports to Japan; reduction of tariffs on Australian agricultural exports; Australian service providers equal access as other preferred trading partners; enhanced recognition of professional qualifications; raising screening threshold for Japanese investment in Australia.
Under negotiation			
10) Australia-China	NA, neg. began 2005	China	Removal of tariff and non-tariff barriers, regulatory barriers, which restrict services; measures to encourage greater foreign investment between China and Australia.
11) Australia-Gulf Cooperation	NA, neg. began 2007	Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, UAE	Reduction of tariffs and other barriers to exports of livestock, dairy vegetables, sugar and wheat; market access for AU service exporters; support greater investment flows; maintain level playing field for AU auto exports.
12) Australia-India Economic Cooperation	NA, neg. began 2011	India	Reduce impediments to trade and investment flows.
13) Indonesia-Aust. Economic Partnership	NA, neg. began 2009	Indonesia	Reduce impediments to trade and investment flows.
14) Pacific closer economic relations	NA, neg. began 2009	Cook Islands, Micronesia, Kiribati, Nauru, NZ, Niue, Palau, PNG, Marshalls, Samoa, Solomon Islands, Tonga, Tuvalu, Vanuatu	Greater economic and trade connections to support growth and employment; help to build trade capacity.
15) Regional Comprehensive Economic	NA, neg. began 2012	China, Japan, Korea, Singapore, NZ, Thailand, Malaysia, India, Indonesia, Myanmar, Laos, Cambodia, Philippines, Brunei, Vietnam	Help to provide a basis for more open trade and investment across the region; done in tandem with the Trans-Pacific Partnership.
16) Trade in Services Agreement	NA, neg. began 2013	Includes 50 WTO members, including 28 European nations	To support WTO General Agreement on Trade in Services.
17) Trans-Pacific Partnership	NA, AU neg. began 2008	Brunei, Chile, New Zealand, Singapore, US, Peru, Vietnam, Malaysia, Mexico, Canada, Japan, Taiwan, Korea	Common rules for trading across Asia-Pacific; help provide AU greater access to markets where it has no other FTAs; support AU exports of education, legal, financial, mining and agricultural services.

Source: DFAT, HSBC

Improving productivity and competitiveness

Productivity growth has slowed in recent years. Total factor productivity has slowed to average annual rate of +0.5% a year since 2004, which is a much slower rate than its +2.2% annual average between 1991 and 2003.

This at least partly reflects that Australia's reform agenda, which had great momentum in the 1980s and 1990s, has stalled over the past decade. This has left Australia with an inefficient tax system, an overly burdensome regulatory environment and congested infrastructure. A stymied reform agenda has been one of the 'curses' of the resources boom, as the early success from rising commodity prices discouraged reforms (see Bloxham, P. (2011) '*Does Australia have a resources curse? The challenges of managing a mining boom*', 18 August).

Reform of Australia's tax system ought to be a priority for the government. Tax reform should focus on shifting the mix of the tax system away from direct taxes on personal and corporate income towards indirect taxes, which are less likely to distort economic behaviour. The option of broadening the base and lifting the rate of the goods and services tax ought to be considered.

Another priority ought to be simplification of the regulatory environment. As discussed above, Australia performs poorly in international comparisons that measure the ease of complying with government regulation (118th among 138 WTO members). Somewhat comparable countries rank ahead of Australia, with Canada at 47th and New Zealand at 13th on this metric.

Australian policymakers also need to remain focused on finding ways to improve Australia's infrastructure. The federal government's plans to ramp up infrastructure spending and the state government's plans to sell existing assets to fund new infrastructure are steps in the right direction. Market solutions also ought to be considered.

A challenge to Australia's competitiveness has been the persistently high level of the Australian dollar (Chart 37). It remains over-valued on most metrics and is somewhat constraining Australia's ability to compete in exports, particularly outside of commodities. At the same time, however, there are some signs that the high currency has been helping to lift Australia's productivity growth over the past year or so. Faced with the high currency, businesses have been forced to find other ways to remain competitive, by cutting costs and innovating.

37. High AUD forcing businesses to adjust

Source: RBA

Encouraging foreign investment

Australian policymakers should continue to strive for as a much transparency, clarity and consistency about foreign investment rules and restrictions as possible. Beyond fairly low levels of foreign investment (criteria are in Table 38 below), Australia's current system involves a case-by-case examination by the Foreign Investment Review Board (FIRB) to assess whether significant investments are deemed to be in line with Australia's 'national interest'.

Table 38. Foreign investments needing government approval

Criteria for requiring FIRB approval	
1) 'Substantial interest'	Ownership involving 15% or more for individuals; 40% for several persons in local business worth over AUD248m
2) Media	Over 5% ownership of the media sector
3) Qantas	Over 49% ownership of Qantas airlines
4) Airports	Over 49% ownership of an airport
5) Ships	Over 49% ownership of an Australian registered ship
6) Telstra	Over 35% ownership of Telstra (individuals limited to only 5% without approval)
7) Real estate	Approval required for purchases of property by foreign persons, although some exemptions apply for temporary residents and working visa holders

Source: FIRB website

To determine if foreign investment beyond these limits is approved, the Australian Treasurer receives advice from the FIRB. However, the rationale for FIRB recommendations is often reported with significant delay or not at all, making it difficult for foreign investors to fully understand which investments are likely to succeed or be rejected. While the vast majority of applications are accepted, clarity about the reasoning for any rejections is important so that foreign investors better understand which assets are accessible and which are not.

Growing Asian opportunities

Policymakers can help to improve the operating environment for local and foreign firms in Australia, but in the end, the onus is on businesses to take best advantage of the economic opportunities that exist.

Local firms should remain focussed on streamlining their processes and innovating in order to improve their productivity and competitiveness. Australian firms should continue to be outward-looking in their approach, given the domestic market of only 23m people is far outweighed by a potential market of over 3bn people in Asia. Opportunities exist not just within Australia's domestic market, but beyond the country's borders and particularly in the rapidly growing Asian markets.

Foreign firms should continue to see Australia's economy as a profitable place to invest. Policymakers can help to make Australia more attractive to foreign investment. Australia's recent economic success and our view that growth will continue already make it an attractive proposition, particularly given the tougher economic conditions in most of the developed world. Australia remains a useful platform for Western investors to increase their exposure to the Asian growth story, albeit indirectly. Foreign investment from Asia is also growing strongly, albeit off a low base. As trade ties grow, Australia's population becomes more Asia-integrated and Asian financial markets develop, it seems likely that direct financial links between Australia and Asia will also increase.

As this report suggests, we see significant opportunities for growth in Australia as it continues its long pivot towards Asia.

Forecasts

HSBC's forecasts for Australia

	Year-average			Year-ended						
	2013	2014	2015	Q114	Q214e	Q314e	Q414e	Q115e	Q215e	Q315e
%*										
AUSTRALIA										
GDP	2.4	2.8	3.2	3.5	2.7	2.6	2.5	2.4	3.1	3.5
Consumption	2.0	2.6	2.7	2.8	2.5	2.5	2.4	2.6	2.7	2.7
Public consumption	1.1	1.6	1.6	1.9	1.9	1.3	1.5	1.5	1.6	1.7
Investment	-1.8	-2.8	0.1	-1.7	-3.3	-3.7	-2.7	-2.2	-0.4	1.2
- Dwelling	2.0	9.9	6.0	8.0	8.8	11.9	11.1	7.8	6.4	5.3
- Business	-1.9	-6.0	-3.0	-4.0	-5.7	-8.1	-6.2	-5.7	-3.6	-1.7
- Public	-5.3	-4.0	5.2	-2.7	-6.8	-2.6	-3.9	0.2	4.5	7.7
Final domestic demand	0.9	1.1	2.0	1.6	1.0	0.8	1.1	1.3	1.9	2.3
Domestic demand	0.3	0.5	2.0	0.9	0.2	0.4	0.4	1.3	1.9	2.3
Exports	6.5	8.5	8.9	10.4	7.1	8.0	8.7	6.8	8.9	9.5
Imports	-2.2	-2.6	4.0	-2.2	-5.6	-2.1	-0.5	2.0	3.8	4.9
GDP (% quarter)	--	--	--	1.1	0.2	0.6	0.7	1.1	0.8	0.9
CPI**	2.4	2.8	2.9	2.9	3.0	2.7	2.7	2.8	3.0	2.9
Trimmed mean**	2.4	2.7	2.9	2.7	2.7	2.7	2.6	2.9	2.9	2.9
Unemployment rate	5.7	5.8	5.6	5.9	5.9	5.8	5.7	5.6	5.6	5.5
Labour price index	2.9	2.9	3.6	2.6	2.7	3.0	3.2	3.4	3.5	3.6
Current A/C (%GDP)	-3.2	-1.7	-1.0	-1.4	-1.9	-1.8	-1.6	-1.3	-1.2	-1.0
Terms of trade	-4.2	-4.8	-2.1	-3.7	-6.4	-4.3	-4.7	-4.6	-2.2	-1.2
Budget balance (%GDP)	-1.2	-3.1	-1.8							
Capital city house prices	6.6	8.6	7.7	10.9	8.7	8.2	6.8	7.2	8.8	8.2
Private sector credit	3.3	5.4	6.2	4.4	5.2	5.8	6.2	6.5	6.1	6.1
USD/AUD (end period)	0.89	0.86	0.86	0.93	0.93	0.87	0.86	0.86	0.86	0.86
Cash rate (end period)	2.50	2.50	3.50	2.50	2.50	2.50	2.50	2.75	3.00	3.25

Source: ABS, RBA, HSBC forecasts
*unless otherwise specified; **includes the effect of the carbon tax from Q312

Notes

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Disclosure appendix

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