ECONOMIC RESEARCH PAPER

China: Economic Reform and Implications for Western Australia

JANUARY 2003

Department of Treasury and Finance
Government of Western Australia

The Department of Treasury and Finance acknowledges the contribution of the following officers to the preparation of this publication, who can be contatced for further information about its content:

Kurt Sibma   Graduate Policy Officer, Economic and Revenue Policy   Tel: (08) 9222 9824
David Smith   Director, Economic and Revenue Policy   Tel: (08) 9222 9161

A copy of this paper is available on the Department of Treasury and Finance Website at:
www.dtf.wa.gov.au

Department of Treasury and Finance
197 St Georges Terrace
PERTH WA 6000
Telephone: (08) 9222 9222
Facsimile: (08) 9222 9117
Website: www.dtf.wa.gov.au

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CHINA: ECONOMIC REFORM AND IMPLICATIONS FOR WESTERN AUSTRALIA

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EXECUTIVE SUMMARY

The recent signing of the 25 year contract to supply China's fast growing Guandong Province with Liquified Natural Gas from the North West Shelf project has highlighted the importance of China to the Western Australian economy. However, the potential for links between the two economies extends well beyond this single deal. Understanding the Chinese economy – its opportunity and its challenges and its developing potential links with our State – is an essential ingredient to better understanding the future of the Western Australian economy.

With a population approaching 1.3 billion, and an annual economic growth rate of around 10% sustained over the past two decades, China has become a considerable economic force. The Chinese economy is now the sixth largest in the world, the seventh largest exporter, and the eighth largest importer of merchandise.

The Chinese Government continues to promote an optimistic economic forecast for the country. In October 2000, the Central Committee of the Chinese Communist Party completed a new five-year plan in which it committed to a long-term target of doubling its $US1 trillion economy by 2010. However, despite the significant achievements that China has made since instituting reforms two decades ago, China still faces a number of complex internal and external challenges in the years ahead.

In particular, China's inefficient state-owned enterprise sector continues to present a threat to sustained economic growth. While the Government has committed to reform, this will entail considerable social costs by adding to the unemployment problem in China. The banking sector is also of particular concern, with each of the major state banks suffering from declining capital asset ratios and losses on loans to state enterprises. Conservative estimates now show at least a quarter of outstanding bank loans are non-performing. While the Government has made progress in reforming the financial sector, the process is far from complete.

On an external level, China faces some significant challenges associated with its accession to the World Trade Organisation (WTO). Under its protocol of accession, China has agreed to a demanding set of liberalisation conditions (which some say are substantially more demanding than those required of other WTO members). China has also been adversely affected by the general downturn in the international economy over the past year. Of particular concern are economic conditions in the United States and Japan, which together account for approximately 40% of China's exports, although China's exports seem to be holding up well.

Despite these challenges, there is much cause for optimism. In the long term, China's accession to the WTO will translate into tariff cuts and trade and investment liberalisation, and is generally expected to lead to significant efficiency gains and greater consumer choice. According to the Asian Development Bank, several studies estimate that the long-term benefit of China's WTO membership will be equivalent to 1-2% of GDP.

Western Australia has a substantial interest in China's further domestic reforms and its deepening integration in the global economy. Over the past five years, China's share of Western Australian exports has grown from 5.9% to 10.1%, making it Western Australia's fourth largest trading partner, with exports amounting to $3.1 billion.

Even before the recently announced gas export deal, Western Australia was a considerable supplier of mineral and resource products to the Chinese economy. Our two key commodity exports to China, iron ore and alumina together accounted for around 58% of our total exports to China in 2001. Growth in demand for these commodities is expected to remain strong given the surge in construction and infrastructure investments in China. There are also a number of emerging markets in China that could be quite beneficial for the Western Australian economy. Demand for clean energy in China, such as natural gas to be supplied under the recent deal, is expected to increase rapidly and prospects for Western Australia are positive.

I. ECONOMY

1. BACKGROUND

China's macroeconomic performance and economic reform over the past two decades has been impressive. Since the inception of its economic reforms in the late 1970s, China has had one of the fastest growing economies in the world. Between 1979 and 2000 real gross domestic product (GDP) increased more than six-fold. Over this time its foreign trade has increased from about $20 billion to $475 billion, making it one of the top ten trading countries in the world.

According to official data, China's GDP in 2001 amounted to 9.9 trillion yuan ($US1.1 trillion), making it the sixth largest economy in the world. China has been able to maintain relatively strong economic growth in recent years despite the Asian crisis in 1997 and the recent global economic slowdown. Official data suggest that economic growth in 2001 was 7.3%, and that an annual average rate of 7.8% has been achieved over the past five years. Looking ahead, the Chinese Government is quite optimistic about the country's economic prospects, indicating that it aims to maintain an average economic growth rate of 7% per annum through to 2010.

Key Economic Data

($US billion)	**1980**	**1990**	**1999**	**2000**
GDP	216.2	363.0	997.5	1,076.9
Total Exports (fob)	18.3	62.1	194.9	249.2
Total Imports (cif)	20.0	53.4	165.7	225.1
Current Account Balance	-0.8	13.7	15.7	20.5
Annual Average Growth (%)	**1980-90**	**1990-00**	**1999**	**2000**
GDP	10.1	10.3	7.1	7.4
GDP per capita	8.5	9.2	6.1	7.2
Exports of goods and services	11.0	16.5	13.9	32.0
Imports of goods and services	7.9	14.3	19.1	23.2

Source: World Bank.

It should be noted, however, that, according to the World Bank, official data concerning the Chinese economy tends to overstate actual rates of economic growth. The exaggeration appears to arise primarily because of the procedures used by China's National Bureau of Statistics to deflate output to derive GDP in real terms.

The problem is that the deflators used show a much lower rate of price inflation than alternative measures of inflation. The World Bank has applied alternative deflators to the consumption and investment components of GDP and concluded that the official data may overstate the real rate of growth by as much as 1.3 percentage points per year[1].

While this would still make China one of the five most rapidly growing economies in the world over the last two decades, much of the growth can be explained by capital accumulation supported by an extremely high personal savings rate[2]. In fact, the World Bank estimates that two-thirds of growth in output for much of this period can be accounted for by capital formation. Accordingly, sustained future economic growth will depend increasingly on financial and related reforms that will improve efficiency in the allocation and use of capital.

1.1 Recent macroeconomic developments

Recent economic growth in China has been driven mainly by increases in domestic consumption and investment. After slowing for six consecutive years, domestic consumption growth has accelerated in the past two, with growth of 9.7% in 2000 and 10.1% in 2001. With such a large population and with incomes rising strongly over the last decade, private consumption has the potential to be the driving force of domestic demand in future years.

Expansionary fiscal policy has stimulated growth in private investment, which grew around 12.1% in 2001. One characteristic of investment in 2001 was a sharp rise in flows to the western region, where economic development has lagged far behind that in the central and eastern regions.

Public investment, which accounts for about three-quarters of total investment, has also grown strongly, increasing by 12.9% in 2000. In 2001, the Chinese Government issued a further 150 billion yuan-worth ($US18.1 billion) of Treasury bonds to finance construction activity.

Foreign direct investment (FDI) also continues to stimulate the Chinese economy. China is now the largest destination for FDI, having received an average of $US37 billion annually in the period 1995-2000. In the first half of 2001, FDI was up 38% to $US33.4 billion. The majority of foreign investment is concentrated in export orientated industries, with the labour-intensive manufacturing sector accounting for 56.3% of FDI in 1999.

1 See N Lardy, *China's Unfinished Economic Revolution* (Brookings Institute, Washington, 1998).
2 Although foreign investment in China is large, China runs a substantial trade surplus meaning it is a net exporter of capital.

1.2 Structure of the Chinese Economy

Agriculture

While agriculture remains an important contributor to China's economy, accounting for 16.2% of GDP in 2000[3], the significance of the agricultural sector has fallen markedly over the last two decades. In the early 1980s, agriculture in China accounted for over 30% of the net value of recorded production. Although its relative importance has declined due to the increasing prominence of other industries, the value of production has increased only marginally in recent years. Agricultural production on the whole grew by 2.8% in 2001, following growth of 2.4% in 2000[4].

There are a number of studies now pointing to increasing difficulty for China in sustaining agricultural growth. The availability of water is seen as the major constraint to future agricultural growth. The implication is that to sustain agricultural growth and per capita food consumption, significant infrastructure investment will be required on the part of the Government. However, if China does manage to sustain agricultural growth, it is still likely to fall significantly short of its food grain requirements by 2020[5].

Much of the agricultural sector in China is small-scale (China's average farm size is one of the smallest in the world) and generally uncompetitive in international markets. As this sector has traditionally relied on protection in the form of high tariffs, it faces some significant challenges post-WTO accession.

Industry

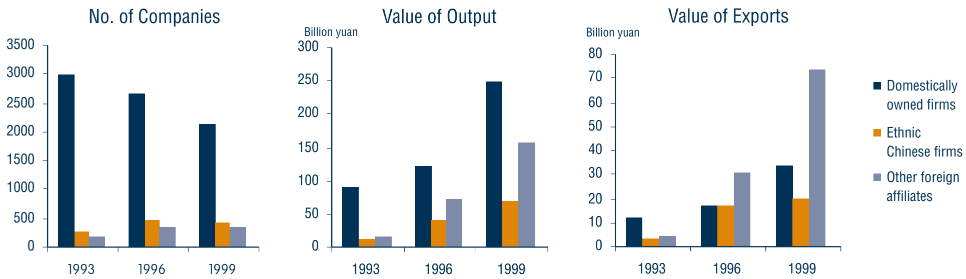
Industrial output in China has changed significantly in recent years, led by the strong performance of foreign-invested enterprises. In 2001, industrial production rose by 8.7% to reach $US477.9 billion, which equates to approximately half of China's GDP. The relative importance of industrial production is greater in China than most OECD countries, largely as a consequence of the latter's more highly developed service sectors.

Growth rates in different industrial sectors continue to shift the composition of output away from state-owned enterprises (SOEs) to the non-state sector, which has grown by two to three times the rate of state-owned industry.

3 In comparison, Western Australia's agricultural sector accounted for approximately 4.1% of GSP in 2000-01.
4 Asian Development Bank, *Asian Development Outlook 2002*.
5 N Lardy, *China's Unfinished Economic Revolution* (Brookings Institute, Washington, 1998) p189.

Much of the growth in industrial production over the past decade has been driven by the manufacture of finished computer hardware. In fact, China is now the world's third largest manufacturer of information technology hardware and is also making efforts to develop its software industry, but is relatively less advanced in this area.

China's Electronics Companies



Source: Chinese Electronics Industry Yearbook[6].

In 2000, very strong growth was recorded in high technology production, with output of new industrial products up 26.3% over the previous year. With the relatively low cost of labour in China, this industry should be a considerable driver of industrial production in coming years.

The construction industry in China is also expected to grow strongly into the future. In fact, infrastructure investment is a key element of China's economic growth potential, with major infusions now scheduled for the road, railway, port, telecommunications, oil and gas, and coal sectors.

The textile, clothing and footwear industry remains an important component of the Chinese economy, again aided by the relatively low cost of Chinese labour. This sector accounts now for around 16% of China's industrial output, while exports of textiles, clothing and footwear account for around one quarter of China's exports.

6 "Domestically owned firms" include state-, collective- and privately-owned firms. "Ethnic Chinese firms" are Hong Kong, Taiwanese firms. "Other foreign affiliates" are foreign affiliates other than ethnic Chinese firms.

1.3 Employment

A significant transformation of the labour force has taken place over the past two decades. According to official statistics, the share of the work force employed in agriculture has declined from 71% in 1978 to just over 51% in 1998. The number of persons employed in agriculture peaked in 1992 at 383 million and has since declined in absolute terms. In large part, this change occurred because of the growing importance of jobs in the non-state sector, where employment expanded by more than 100 million between 1978 and 1995.

The official estimate of urban unemployment in 2001 was 3.6%, slightly higher than in 2000. However, this estimate covers only those registered with the Ministry of Labor and Social Security and does not include workers who have been laid off as part of ongoing SOE reforms. Some analysts estimate that as many as ten million workers have left the state sector since reform began. When these workers are included, urban unemployment could rise to 7% or higher.

In addition to urban unemployment, there is considerable rural unemployment in China. Rural unemployment is difficult to measure, with some estimates ranging from 75 million to 170 million people[7].

Accordingly, unemployment is a significant problem for the Chinese Government. Indeed, it has been estimated that GDP growth of at least 7% per annum is required to maintain the unemployment rate at current levels.

2. TRADE

Since the beginning of its 'Open Door Policy' in 1979, China's international trade has grown substantially. In 2000, China was the world's seventh largest exporter and eighth largest importer of merchandise, with exports totalling $US249 billion (3.9% share of world exports) and imports of $US225 billion (3.4%). In terms of commercial services, China was the 12th leading exporter and 10th largest importer, with exports amounting to $US30 billion (2.1% share) and imports of $US35 billion.

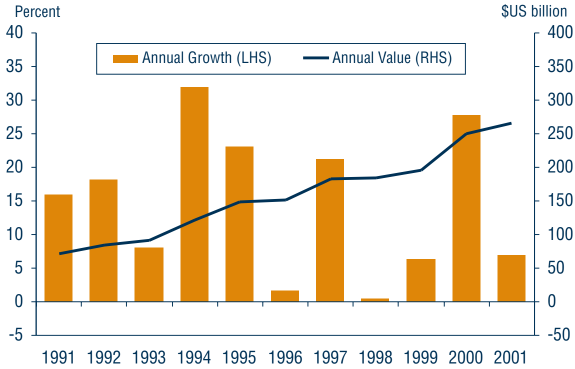
Overall, China's foreign trade surplus in 2001 was $US22.5 billion. In fact, the external sector has been in surplus since 1994 and, as a result, China has accumulated the second highest level of foreign exchange reserves in the world after Japan, amounting to $US147 billion as at 1999.

7 DFAT *Country Economic Review: China p18.*

2.1 Exports

Export growth in China has slowed recently as a consequence of the global downturn in economic activity and a high base in 2000. In 2001, exports increased by 6.8% to $US266 billion, following very strong export growth of 27.8% in 2000.

Export Growth



Source: WTO.

While trade barriers in the form of subsidies and tax rebates have contributed to export growth in recent years, trade reforms also have contributed to the success of China's export industries. The simplification of import/export approval procedures for controlled commodities, extension of trading rights and partial yuan convertibility have all contributed to this expansion.

As with most countries in the early stages of industrialisation, China relies mainly on labour-intensive export industries, where its comparative advantage lies. Industries that have grown rapidly over the past two decades include machinery and electronics, clothing, footwear and textiles, which together accounted for over half of total exports in 2000.

China's Major Exports

Commodity Description	Jan – Jun 2001 ($US million)	% Change*
Electrical machinery & equipment	22,974	14.1
Power generation equipment	15,563	26.4
Apparel	14,534	-0.2
Footwear	4,995	2.2
Iron & steel	4,074	-9.0
Mineral fuel & oil	3,972	28.1

* Compared with same period a year earlier.
Source: PRC General Administration of Customs, China's Customs Statistics

China trades predominantly with capital and technology-rich countries, which complement its domestic production. In contrast, it tends to compete with the South-East Asian and South Asian economies in international markets due to similarities in their economic structure, and the relatively low cost of labour.

The United States is China's largest export market, accounting for 20.7% of China's exports in the first three quarters of 2001. Exports to the United States increased by 4.8% from January to September 2001, compared with the same period a year earlier. Despite a depressed Japanese economy, China's exports to Japan also grew strongly over this period, with an increase of 10.0% recorded.

China's Major Export Destinations – 2001

Country	$US million	% Change	% of Total Exports	Rank
United States	5,764.1	4.3	21.7	1
Hong Kong*	4,654.7	4.6	17.5	2
Japan	4,495.8	7.9	16.9	3
Korea	1,252.1	10.9	4.7	4
Germany	975.4	5.1	3.7	5
Netherlands	728.2	8.9	2.7	6
United Kingdom	678.0	7.5	2.5	7
Singapore	579.2	1.1	2.2	8
Taiwan	500.0	-0.8	1.9	9
Italy	399.3	5.0	1.5	10
Australia	**357.0**	**4.1**	**1.3**	**11**
Canada	334.6	6.0	1.3	12

* Includes goods for re-export.
Source: Ministry of Foreign Trade and Economic Cooperation, PRC

Hong Kong is still an important entrepôt port for much of China's trade. In 1998, re-exports through Hong Kong amounted to US$89 billion – representing 48% of China's total exports. Although China's capacity to ship goods directly has increased in recent years with the development of modern airport and port facilities, Hong Kong's superior infrastructure provides mainland producers with legal, insurance, marketing and transport services. (Hong Kong remains the only deep-water port along China's coast.) Hong Kong's extensive use of English is an added advantage for international business.

Australia currently ranks as China's 11th largest export market, mainly for textiles, but increasingly for electronic equipment.

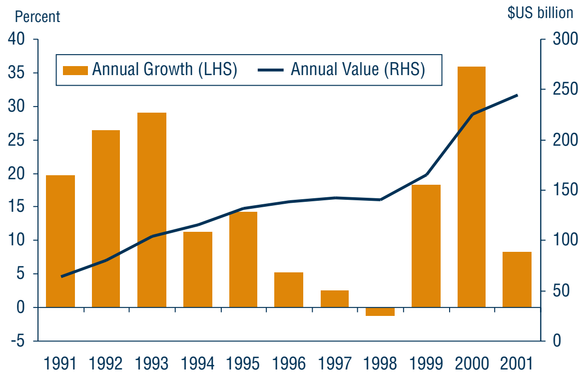
2.2 Imports

As with exports, imports of goods and services in China have increased significantly over the past two decades. In 1980 total imports, as a percentage of GDP, equalled 7.9%. This rose to 14.3% in 1990, and to 23.2% in 2000.

In 2001, import growth in China fell sharply, falling from 35.8% in 2000 to 8.6% (US$221.2 billion). The surge in import growth in 2000 was largely driven by the pick-up in domestic demand, an increase in the oil price, and higher imports by domestic enterprises seeking to upgrade technology in anticipation of increased competition surrounding WTO entry.

With China's entry into the WTO and the liberalisation of trade policies, including fewer tariff and non-tariff barriers, imports are expected to grow steadily over the next few years and exceed export growth.

Import Growth



Source: WTO

Japan currently stands as China's largest import source, supplying 17.6% of China's imports in 2001. The United States is another major import source for the Chinese economy. Over 2001, imports in China from the United States increased by a strong 17.2%. Australia currently ranks as China's 9th largest import source, with a 2.2% share of China's total imports. In terms of commercial services (such as education), however, Australia ranks as one of China's primary import sources.

China's Major Import Sources – 2001

Country	$US million	% Change	% of Total Imports	Rank
Japan	4,279.7	3.1	17.6	1
Taiwan	2,733.9	7.2	11.2	2
United States	2,620.2	17.2	10.8	3
Korea	2,338.9	0.8	9.6	4
Germany	1,377.2	32.3	5.7	5
Hong Kong	942.3	-0.1	3.9	6
Russia	795.9	37.9	3.3	7
Malaysia	620.5	13.2	2.5	8
Australia	**542.6**	**8.0**	**2.2**	**9**
Singapore	514.3	1.6	2.1	10

Source: Ministry of Foreign Trade and Economic Cooperation, PRC

Capital equipment, intermediate goods and raw materials used in export processes represent a significant share of China's total imports. Despite its considerable mineral reserves, China is the world's third largest importer of minerals. This is partly a reflection of the fact that many of China's minerals are located in the north or inland areas, where access to coastal areas is limited. In addition, reserves of major minerals such as iron ore and alumina are limited, mainly low grade and less competitive in the international market place.

China's Major Imports ($US Billion)

Commodity Description	Jan - June 2001	% Change
Electrical machinery & equipment	26.6	18.3
Power generation equipment	19.3	22.4
Mineral fuel & oil	9.4	7.7
Plastic & articles thereof	7.5	15.0
Iron & steel	**6.5**	**32.9**
Inorganic & organic chemicals	5.0	9.5
Medical Equipment	4.4	9.5

Source: PRC General Administration of Customs, China's Customs Statistics

China has been a net importer of oil since the early 1990s. In fact, China is now the second largest energy consuming country in the world. Demand for crude oil is projected to grow annually by 4% in the next decade, while the ratio of domestic supply to total demand for oil, including refined products, is forecast to fall from the present 78% to 71% in 2010 and to 62% in 2020.

Demand for cleaner energy sources, such as LNG, is also projected to increase significantly in the next decade as China's ability to satisfy this demand from its own sources remains limited. As the recently announced LNG export deal illustrates this can present lucrative opportunities for Western Australia's LNG exporters. The implications of this development for Western Australia are discussed in part IV of this paper.

II. OUTLOOK

1. IMPEDIMENTS TO GROWTH AND INVESTMENT

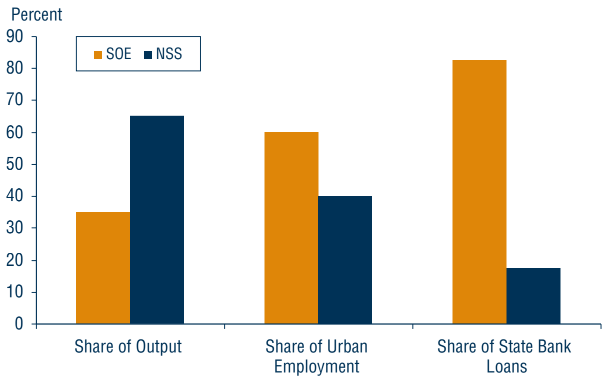
1.1 The State Owned Enterprise Problem

One of the consequences of the economic reforms in 1978, designed to transform China from a closed and planned economy to a more open 'socialist' economy, was the creation of large state-owned enterprises (SOEs). These enterprises have become increasingly inefficient and now present a considerable threat to China's ability to maintain strong economic growth.

Currently, there are around 340,000 SOEs, approximately 40% of which are unprofitable, while half are believed to have operated at only 60% capacity[8]. Despite their dominance of the urban economy (SOEs employ around 70% of the urban workforce), SOEs contribute less than 30% of China's industrial output, compared with 60% a decade ago[9].

This is because China's state enterprises typically have lower labour productivity, a higher incidence of underemployment and produce poorer quality goods than the private sector. SOEs are also often highly protected and many are being kept afloat by government subsidies and loans, which state banks are compelled to provide. This has the effect of draining resources from a more profitable private sector, and at the same time undermines the soundness of the banks.

State Owned Enterprises (SOE) & Non-State Sector (NSS)



Source: Macquarie Bank

8 DFAT *Country Economic Review*, Macquarie Bank "China: Can reform be fast enough? " (1999) *The Macquarie Irregular*, at p14.
9 DFAT at p17.

The Chinese Government has recognised that SOE reform will provide an essential transition for China from a partly controlled, domestically focussed economy, to a more open and efficient participant in the global economy.

As part of the reform process, the authorities have announced plans to close down one-third of the 40% of large and medium-sized SOEs that are estimated to be unprofitable[10]. The Government also intends to corporatise many of the SOEs and allow greater private sector involvement generally.

The major risk and potential impediment to SOE reform is the potential displacement of workers. State enterprises currently employ around 60% of urban employees. At present, these employees have housing, as well as pension, health and education benefits provided – entitlements that would not be made available in the private sector. Rising redundancies will not only have a negative impact on demand, but could spark social and political unrest.

While the Government is adamant that SOE reforms will continue, it is inevitable that these will proceed slowly while the authorities focus on establishing a social security network.

1.2 The Banking Sector

China currently faces quite a serious problem in relation to its four major state-owned banks. For the past two decades, these banks have channelled funds into the SOE sector, with lending decisions largely based on political rather than economic criteria. Some analysts now estimate that non-performing loans (NPLs) may account for between 25% to 50% of all lending from the four, big state-owned banks[11]. The Government has been unable to recover these debts largely because it has a conflict of interest with the SOEs. It is both debtor, as owner of SOEs, and creditor, as owner of the state banks.

The establishment of four asset management companies (AMCs) in 1999 to resolve the problem was seen as a major step in reforming the financial sector. About $US157 billion of NPLs, equivalent to about 10% of the total assets of the four banks, were transferred to the AMCs by June 2000[12].

10 Macquarie Bank "China: Can reform be fast enough?" (1999) *The Macquarie Irregular*, at p14.
11 See D Lague, "A Finger in The Dyke," *Far Eastern Economic Review* 12 (2001) pp30-32.
12 Ibid.

While the transfer of a significant proportion of NPLs to the AMCs will improve the financial position of the banks, the ultimate success of the AMCs will depend on the rate of recovery they achieve. The preferred method by the AMCs to resolve the NPL problem have been debt equity swaps. For the AMC initiative to succeed, the debt equity swaps must be accompanied by legal powers enabling the AMCs to restructure the management and operations of the enterprises in which they have become stakeholders.

Even with the best efforts of the AMCs, only a small proportion of the NPLs acquired from the banks will be recovered. Optimistic assessments put the percentage that can be recovered at 30%, while others put it in the 15-20% range[13]. This means that significant fiscal support will be required to prevent the AMCs from becoming non-viable.

For the first time, China recently turned to foreign consortia to recover NPLs. A private consortium led by Morgan Stanley attempted to recover what it can from a parcel of non-performing loans, from 254 debt-stricken enterprises with a face value of $1.3 billion[14]. More debt sales are now expected, with the other three AMCs all planning auctions.

This arrangement is seen as significant in terms of the Government's plan to float the state-owned banks. Whether or not this process will be successful, however, will again depend on support from the legal system.

Despite these developments, the NPL problem remains a significant one. Official figures show that NPLs are continuing to accumulate. One reason is the continued pressure on the banks to support the State’s active fiscal policy. Curbing loans to SOEs, which make up 80% of all lending, will alleviate the strain on the banking sector, but at the same time increase the social and political risk of enterprise closures and growing unemployment. However, if banks are unable to conduct their business on a commercially sound basis, the risk of a financial crisis will become more likely[15].

13 See D Lague, “A Finger in The Dyke,” *Far Eastern Economic Review* 12 (2001) pp30-32.
14 Ibid.
15 The need for reform has become even more pressing since China’s accession to the WTO – see Part 3

1.3 The Yuan

China's exchange rate (the yuan), is currently determined under a managed floating exchange system. Accordingly, China has *current account* convertibility in that there are no restrictions on foreign currency payments and transfers for trade-related international transactions. However, it does not have *capital account* convertibility – this would require the removal of foreign exchange and other controls on capital flows.

To prepare the economy for the post-WTO era, the People's Bank of China is considering introducing mechanisms to gradually allow a greater role for market forces in determining the exchange rate.

Nevertheless, at this stage, only domestic investors are entitled to invest in the domestic currency 'A' share markets, while foreigners may only invest in 'B' shares listed on the two exchanges. Transactions in B shares are denominated in the yuan, but conducted in foreign currencies. State-held shares, which cannot be traded, account for more than 60% of the total number of shares issued.

Thus, market capitalisation is relatively low and the overall market is illiquid. This enforces the dependence of enterprises on bank credit, and has a negative impact on non-state enterprises that would benefit from a more efficient source of capital outside the banks.

It is expected that the 'A' and 'B' share-markets will be merged eventually as the Government implements its new Securities Law. However, in order to effectively open the 'A' share-market to foreign investors, China would have to make its currency fully convertible.

Over the coming few years, Chinese authorities are expected to commence a series of reforms (in line with WTO guidelines) to allow more flexibility in the exchange rate mechanisms. The precise nature of these reforms is, however, subject to much debate and speculation.

At present, it appears that many foreign firms have postponed investment in China due to the difficulties of obtaining local currency. Once these restrictions are minimised or lifted completely, it is anticipated that investment in China will grow even further.

2. POSITIVES

2.1 Role of the Non-State Sector

In contrast to the state-owned sector, the non-state sector in China is performing very well. This sector, which comprises private companies and individuals, foreign-funded enterprises, urban collectives and village enterprises (either owned by local government authorities or groups of individuals), generates around three-quarters of total export *growth* and produces two-thirds of industrial output. The non-state sector has been estimated to account for 75% of GDP[16].

In recognition of the role private industry plays in driving growth and absorbing surplus workers from the SOEs, the Government has amended the constitution to describe individual, private and other non-state sectors as an 'important component' of the socialist market economy.

Previously, these sectors were described as 'complementing' the socialist economy. This amendment has made it somewhat easier for private businesses to obtain loans from banks, which have historically focussed overwhelmingly on state enterprises. Indeed, the Government has encouraged banks to lend more to individuals and private enterprises.

In 2000, the Ministry of Foreign Trade and Economic Cooperation has also issued import and export permits to 450 private companies, allowing them to conduct external trade. The scope of these permits has since been extended to all private firms within a certain scale of operation. (Such trade was previously limited to government-approved medium and large SOEs.)

In the years following WTO accession, the role of the non-state sector should increase significantly. In fact, it has been estimated that the number of trading enterprises could expand from just 7,000 at present, to over 10 million in the next decade. Further reform in the areas of market entry, finance, land-use rights, and enforcement of private property rights will help further develop the private sector.

16 Macquarie Bank "China: Can reform be fast enough?" (1999) *The Macquarie Irregular*, at p18.

2.2 Housing Sector

The housing sector in China has the potential to be an important source of economic growth. In the past, there have been a number of factors inhibiting growth in this industry. Housing prices have historically exceeded purchasing power in China: on average, the price of a home in China has been around 10 times annual household income[17]. Additionally, banks have been unwilling to extend long-term loans to fund mortgages, offering mainly 3-5 year loans, due to poor legal protection for creditors and uncertain property rights.

However, given that private ownership of urban housing is a mere 5%, there is significant potential for growth in China's housing industry in coming years, particularly if urban household income continues to grow steadily. In 1999 alone, an estimated $US23 billion was invested in the construction of low cost residential housing[18].

In recent years, the Government has implemented a number of initiatives designed to encourage development of private housing. These include: cuts in taxes and administrative fees on property development and sales; boosting the average rentals on state-owned housing to 15% of monthly household income (compared to 3% previously); and allowing all commercial banks to provide long-term (15 year) mortgage loans.

Reforms of the SOEs are also likely to provide a significant boost to the housing sector, as former SOE workers are forced to purchase their own houses rather than having them provided. The creation of public housing funds, into which state companies and their employees contribute a proportion of each worker's monthly salary, will help workers purchase their own homes. Ultimately, the objective is to commercialise the entire housing and real estate sector by encouraging people to purchase their own housing.

17 Ibid at p13.
18 Ibid.

III. WTO ACCESSION

1. CHINA'S COMMITMENTS

China formally acceded to the World Trade Organisation (WTO) on 11 December 2001, after almost 15 years of negotiations. Under the terms of membership, China has agreed to undertake a series of important commitments to open and liberalise its regime to better integrate into the world economy. In fact, according to some, the terms of China's protocol of accession are substantially more demanding than those made by other WTO members, with membership now entailing liberalisation of a much broader range of domestic economic activity.

China's entry into the WTO has the potential to open significant potential commercial opportunities for foreign firms and contribute to the further transformation of the domestic economy. Several studies estimate that the long-term gain from WTO membership to China will be equivalent to 1-2% of GDP, though these benefits may take time to materialise[19]. Importantly, increased competition on state owned banks and enterprises should force badly needed structural reforms.

The particulars of China's commitments, and their potential impacts, are outlined below.

1.1 Goods

The Chinese Government has undertaken to gradually eliminate trade barriers and expand market access to goods from foreign companies. In particular, China has committed significant reductions in tariffs that will bring the average level to under 10% by 2005. Over the course of 2002, tariff rates on more than 5,300 items will be reduced, with China's average tariff rate scheduled to drop from 15.3% to 12% over the year.

Agriculture

After implementing all the commitments made, China's average tariff level will decrease to 15% for agricultural products. The introduction of a tariff rate quota system will take the tariff rate for key agricultural commodities, including wheat, to almost zero. China has further agreed to limit subsidies for agricultural production to 8.5% of the value of farm output. As previously mentioned, the reduction of these tariffs could create significant challenges for the Chinese agriculture sector.

19 Asian Development Bank, *Country Economic Review: People's Republic of China*, October 2000 at p. ii

The key challenge for the Government will be to enable farmers to shift to their more competitive labour-intensive sectors such as fruit, vegetables, meat and dairy products, where their comparative advantage lies.

Energy

Under its WTO agreements, China will abolish the import quotas and licences for energy products within 5 years after WTO entry[20]. Further, in order to ensure that restrictions to market access decrease progressively over this period, quotas will grow from the current level at a 15% annual rate before finally being abolished[21]. Tariffs on energy products have been considerably reduced, with tariffs on imported crude oil and natural gas eliminated upon WTO accession.

Minerals

Among its WTO commitments concerning minerals, China has agreed to reduce tariffs on alumina (Western Australia's second largest export commodity to China) from 18% to 8%, and gold from 9% to 7%.

Textiles

Upon accession, China became a party to the WTO *Agreement on Textiles and Clothing* and will become subject to its rights and obligations. As for all WTO members, quotas on textiles will end at 31 December 2004.

The relaxation of import restrictions may well have significant implications on the textile and clothing industry in China. Access to new textiles and fibres from around the world should promote the further development of this sector. In fact, the World Bank has estimated that clothing production could quadruple, and that China could account for an amazing 47% of world clothing exports by 2010.

Automotive

Tariff reductions in the automotive industry are quite substantive. The import tariff on some imported cars was cut on January 1 2001 from 70-80% to 43.8-50.7%, with the import quota for Japanese automobiles also increasing significantly. As the automotive industry in China has developed under these high tariff walls, domestic producers will come under considerable competitive pressure.

20 Asia Research Centre, China: Energy Policy and Natural Gas Use, Murdoch University, Perth, 2001, at p40.
21 Ibid.

1.2 Services

China has committed to opening service sectors such as telecommunications, distribution, banking, insurance, asset management and securities to direct foreign investment. Certain sectors of the economy, such as distribution, telecommunications, and financial services, remained closed or largely closed to foreign direct investment.

Telecommunications

Upon accession, foreign service providers will be permitted to establish joint venture enterprises, without quantitative restrictions, and provide services in several cities. Within three years of accession, foreign investment in the joint venture can rise to 49%.

Banking

Foreign financial institutions will be permitted to provide services in China without client restrictions for foreign currency business. Within two years of accession, foreign financial institutions will be permitted to provide local currency business services to Chinese enterprises. By 2006, foreign financial institutions will be permitted to provide services to all Chinese clients. These commitments could pose significant challenges for China's financial sector.

It has been estimated that by 2005, around 10-15% of savings in state banks could be transferred to foreign institutions.

2. PROBLEMS AND BARRIERS IN THE POST-WTO MARKET

Despite the considerable trade concessions made by China for its WTO entry, some commentators question the extent to which it will be able to implement its commitments. One concern is that, in an environment where the regulatory power of the central government is declining, local protectionism is becoming one of the defining features of the economy. Thus, the real challenge for Beijing will be whether WTO rules can be implemented at local levels.

2.1 Implementation at a Local Level

At present, locally owned enterprises produce more than half of the total industrial output in China. These local enterprises are the most important source of revenue for local authorities. Local authorities therefore have a vested interest in developments affecting these enterprises.

China's entry into the WTO will adversely affect those local producers who will face serious competition from foreign companies. Due to the close links between the economic viability of these local enterprises and local government revenue, local authorities may well be tempted to intervene.

Local officials have many means to subsidise and protect local industries. Thus, even if the central government has a genuine intention to create a fair and competitive national market, local government interests may shape actual markets in China. Foreign companies wanting to invest in China may, therefore, be constrained by specific local policies.

Beijing has taken some action to break down this type of internal protectionism, but it still has a long way to go. The accumulation of power at a local and provincial level represents an enormous challenge for Beijing. Many provinces are ill-prepared and have not even begun to change regulations which protect local companies.

2.2 Continued Government Protection

Another problem likely to be faced by foreign companies is continued government protection notwithstanding its WTO commitments. For example, the Government may be able to effect protection in certain industries through the use of State Trading Companies (STCs), which still dominate many export and import businesses. While in a post-WTO market, STCs will be required to carry out their business on a purely commercial basis, the Government can still easily direct their operations.

Other new trade barriers may also be created to provide protection for certain markets. There have been concerns about China imposing a high threshold for qualifying to become a foreign trade dealer. Foreign and domestic private companies wanting to engage in exports and imports may have to meet strict requirements set by the government on their financial capability, business turnover and the quality of the imported product.

2.3 Other Hurdles

Foreign companies in China still have to face continuing bureaucratic hurdles to gain permission for setting up business in China. Authority and decision-making power in the Chinese bureaucratic system is highly fragmented and foreign companies often find it difficult to determine which government institution has final approval authority.

Further, the Chinese Government may continue to use its regulatory powers that are not subject to the WTO agreement. For example, in the mineral exploration field, the issue of exploration and production licences is not subject to WTO agreement, hence the Government can selectively open the market to foreign companies.

3. SUMMARY

Under its protocol of accession to the WTO, China has agreed to become subject to a set of demanding trade conditions. These commitments may present China with some significant challenges in the short to medium term. In particular, China's agricultural, automotive and banking sectors are likely to be adversely affected. The potential for rising rates of unemployment in the face of increased international competition may exert considerable pressure on the Government.

Despite these challenges, China's accession to the WTO has the potential to transform the Chinese economy. It will impel China to be accountable to an internationally agreed set of rules and bind them to wide ranging economic and systemic changes in order to meet the changes as a part of WTO accession. In the long term, trade liberalisation and further economic reform should facilitate greater economic growth.

IV. IMPLICATIONS FOR WESTERN AUSTRALIA

1. TRADE

Developments in China could well have significant impacts on the Western Australian economy. In 2001, China was Western Australia's fourth largest trading partner. China is the third largest destination for Western Australian exports, worth $3.1 billion, and fifth largest source of imports worth $407 million.

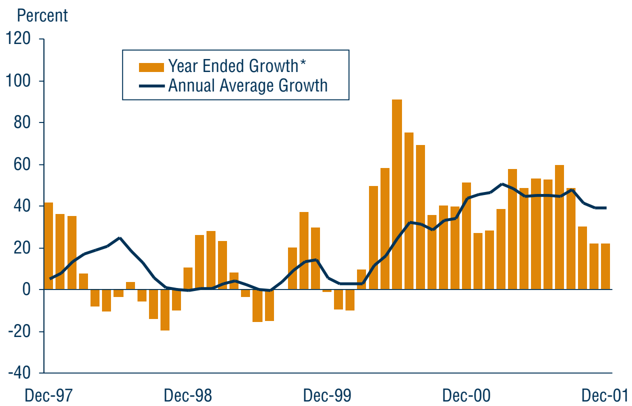
Western Australia's Major Export Destinations – 2001

Country	Value ($m)	Annual Growth	% of Total Exports	Rank
Japan	8,217	3.4	26.4	1
South Korea	3,388	17.4	10.9	2
China	**3,130**	**39.2**	**10.1**	**3**
United States	2,357	-9.8	7.6	4
Taiwan	1,847	6.5	5.9	5
United Kingdom	1,578	41.9	5.1	6
Singapore	1,388	-29.4	4.5	7
Hong Kong	821	112.1	2.6	8

Source: ABS Cat. 5432.06.

Western Australia's exports to China have grown considerably over the past two years. In 2001, exports to China rose by 39.2%, following a 43.8% increase in the 2000 calendar year.

Western Australia's Exports to China



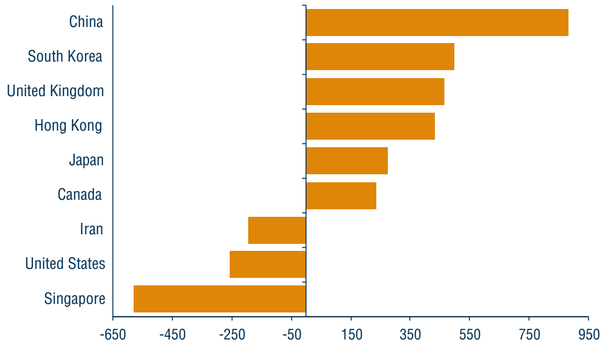
Source: ABS Cat. 5432.06.

In terms of Western Australia's export destinations, China posted the largest absolute increase in 2001, to be $881 million higher than in 2000.

A consequence of this strength is that China has played a significant role in offsetting weaker demand from other markets, including Japan and the United States, over this period.

Change in Export Destinations*

2001 ($m)



* Countries with changes greater than $200 million.

Source: ABS Cat. 5432.06.

In May 2002, the Australian Prime Minister, Mr Howard and the Premier of China, Mr Zhu Rongji, agreed to commence work on a new Framework Agreement to enhance the trade relationship between Australia and China. Senior officials met in Beijing in September to begin negotiations. The decision marked 30 years of relations between the two countries and also, importantly, aimed to strengthen the long-term relationship between the two countries. The recently announced LNG deal, Australia's largest ever export deal, which was announced in October, also bodes well for future trade relations between the two countries.

2. KEY EXPORT MARKETS

A key driver in the development of Western Australia-China trade has been the close complementarity of the two economies. Western Australia exports a considerable amount of its mineral production to China each year. Growth of these exports is expected to remain strong in coming years. In addition, there are a number of emerging service markets which could be quite positive for the Western Australian economy.

2.1 Iron Ore and Alumina

Western Australia's single largest export product to China is iron ore. In 2001, exports of iron ore to China totalled $1.1 billion, representing an increase of 13.3% or $138.2 million compared with a year earlier. Exports of confidential items (essentially alumina) also account for a significant proportion of Western Australia's trade with China. Exports of confidential items to China amounted to $623.8 million in 2001 (an increase of 5.3% from the previous year).

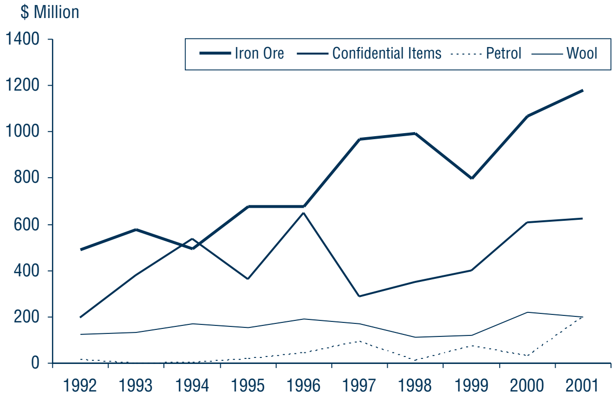
Major Commodity Exports to China in 2001

Commodity Description	Value ($ million)	Annual Growth %
Iron Ore	1,180.0	13.3
Confidential Items	623.8	5.3
Petroleum	204.8	523.1
Wool	201.1	-5.6
Pigments & Paints	84.5	2.1

Source: ABS (unpublished data).

As the chart below illustrates, exports of iron ore and confidential items have grown strongly over the past decade. In real terms, exports of iron ore have increased by an average annual rate of 9.2% since 1992, while exports of confidential items have grown by 12.2% over this period. In comparison, exports of wool have been somewhat subdued, with an annual growth rate of 4.8% over the past 10 years.

WA Commodity Exports to China



Source: ABS (unpublished data); WA Treasury & Finance.

Demand for steel in China in recent years has been driven by a surge in construction and infrastructure investments. In fact, in 2000 China consumed more than 130 million tonnes of steel, surpassing the United States to become the biggest market in the world.

This demand is likely to increase further in coming years, implying even greater demand for iron ore. In fact, there is evidence to suggest that China is still only in the early stages of burgeoning demand. There is a well-established relationship between a country's GDP and steel consumption. Currently, China uses 0.12 kilograms per dollar of GDP, whereas Malaysia, for example, consumes 0.59 kilograms per dollar[22].

Annual demand is forecast by some commentators to increase by 50 million tonnes, to more than 182 million tonnes by 2005[23]. However, no more than 27 million tonnes of excess capacity in China can be identified, implying a gap of 44 million tonnes, that can only be filled by imports or increased productivity[24].

Increased demand in China for steel should translate into increased demand for Western Australia's iron ore[25]. Western Australia can therefore expect the strong growth in iron ore exports to continue. This growth will be especially important in terms of providing a buffer against potential downturns in the Japanese steel industry, on which the State has traditionally relied for its iron ore exports.

Increased demand from China will also serve to boost Australia's bargaining power in negotiating benchmark iron ore prices. In this year's round of annual negotiations, Japanese steel mills sought to reduce the benchmark price, citing recent declines in worldwide steel production. Australian producers, however, have been able to point out that sharp falls in steel production in the United States, Japan and Europe were offset by sharp increases in demand from the Chinese market. China is therefore an important stabilising force for Australian producers in the negotiation of these prices.

2.2 Energy

Another significant development in our resource trade relationship is China's increasing demand for sources of energy. In particular, under its recent five-year plans, China has moved to increase its utilisation of cleaner energy sources such as liquefied natural gas (LNG).

22 J.R. Woetzel, "Overhaul of China's Steel Industry Starts with Attitudes", The Asian Wall Street Journal, January 7-13 2002, p.9.

23 McKinsey & Company in J.R. Woetzel, "Overhaul of China's Steel Industry Starts with Attitudes", *The Asian Wall Street Journal*, January 7-13 2002, p.9.

24 Ibid.

25 China's domestic deposits contain relatively low iron content and are dispersed throughout the country.

At present, coal is the main domestic energy source in China, providing approximately 70% of the country's energy needs[26]. However, the rapid development of this industry in the 1980s and early 1990s resulted in excess capacity and large stockpiles of raw coal. In addition, many coastal cities have banned coal burning for environmental reasons[27].

The result is that demand for clean energy such as natural gas is increasing rapidly. However, China's ability to satisfy this demand from its own reserves is still somewhat limited[28].

As natural gas currently accounts for less than 3% of the country's total energy consumption, there is considerable opportunity for expansion. In fact, China plans to increase its national fuel share of natural gas to 8% by 2020[29]. In particular, gas-fired plants will play a major role in future expansion of power generation in coastal provinces and imported natural gas is expected to provide part of the increased supply requirement.

Thus, with Western Australia's relative abundance of natural gas, the prospect for Western Australian LNG gas exports is very positive[30]. In October 2002, Western Australia's North West Shelf venture was chosen by China to be the sole supplier of LNG to its first LNG project in Guandong province. The first shipment of LNG will be supplied in late 2005, with three million tonnes of LNG supplied each year for 25 years. The contract will be worth around $25 billion in export income for Western Australia and is Western Australia's (and Australia's) biggest ever single export deal. The result is a major win for Australia's energy industry and a huge step forward in promoting a long-term energy partnership between Western Australia and China.

2.3 Wool

The wool industry remains as a significant contributor to the Western Australia's economy, and continues to rank among Western Australia's most important agricultural products. In 2001, China was this State's largest market for wool, with exports to China reaching $201 million. Though growth in exports of wool to China has been relatively subdued in the past, demand is now expected to increase steadily in coming years. This growth will be driven by increased demand finer merino wool and decreased protection under China's WTO commitments. Clothing production in China is expected to benefit significantly in the medium to long term as a consequence of WTO accession.

26 Asia Research Centre, China: Energy Policy and Natural Gas Use, Murdoch University, 2001, p.10.
27 Ibid at p.11
28 In May 2002 China discovered a gas field which is expected to provide 6.5 billion cubic meters of gas annually for the next five years.
29 Ibid at p.23.
30 One caveat to this view surrounds Australia's commitments to limit greenhouse gas emissions under the Kyoto Protocol. While LNG is a relatively clean fuel, the extraction process still emits substantial amounts of greenhouse gases. Therefore, this industry could potentially face limitations in the future in terms of the approval of new projects, as well as increased costs, if greenhouse gas abatement policies are implement. See generally M. Matthewson, "The Economic Impact of the Kyoto Protocol on Western Australia" *Economic Research Articles*, Western Australian Department of Treasury and Finance, 2002 at pp. 31-43.

In fact, World Bank forecasts suggests that clothing production could increase by a factor of four in the years following WTO accession, implying considerable demand for textiles and fibres.

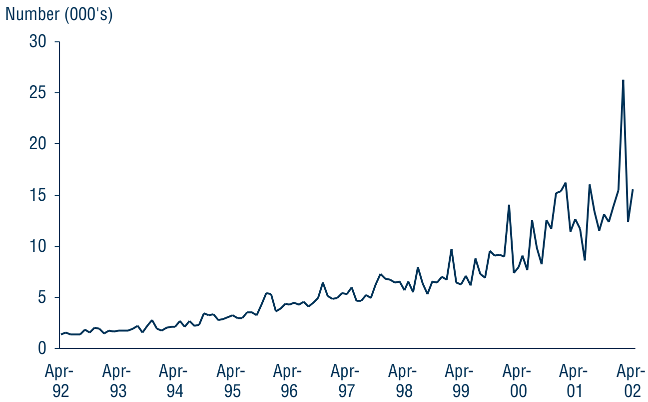
2.4 Tourism

China is now playing a significant role in the development of Western Australia's tourism industry. According to the Western Australian Tourism Commission, this industry currently injects an estimated $4 billion[31] into the Western Australian economy and employs 8.5%[32] of the workforce. While the events of September 11 2001 and the collapse of Ansett Airlines have had a deleterious effect on tourism generally, Western Australia can look forward to an increase in demand on the part of Chinese tourists.

With increased earning power and fewer international restrictions, the Chinese are heading abroad in increasing numbers. Around 10.5 million Chinese travelled abroad in 2000 (up 13% from 1999), making it one of the world's fastest growing tourist markets[33]. This growth rate is expected to continue as the Chinese Government considers relaxing its restrictions on outbound tourism. For example, the World Tourism Organisation has estimated that in two decades, approximately 100 million Chinese will travel abroad annually.

China's granting to Australia of Approved Destination Status (ADS) in 1997 has facilitated considerable growth in Chinese tourism to Australia[34] (without an ADS, Chinese citizens require an official or business reason to travel to the country concerned).

Chinese Short-Term Visitor Arrivals



Source: ABS Cat. 3410.08.

31 Western Australian Tourism Commission estimate.
32 Ibid.
33 China National Tourism Administration
34 China currently has ADS agreements with 22 destinations, which are situated mainly in Asia. Notably, the United States and countries in the EU do not have an ADS.

Outside Asia and the United States, Australia is now China's most popular tourist destination. Short-term visitor arrivals from China increased by 38% in 2001 to reach 171,800. This was the largest increase from Australia's major source countries. As a consequence, China is now Australia's sixth-largest tourist source, with a 4% share of visitor arrivals[35]. Strong growth in tourism from China is expected to continue – current forecasts suggest that over one million Chinese will visit Australia by 2010[36].

There is also evidence to suggest that Chinese tourists are relatively large spenders. According to the Australian Tourism Commission in Shanghai, the average Chinese tourist stayed 10 nights in Australia and spent around $4,500[37].

The outlook for Western Australia's tourism industry is therefore quite positive. Given our regional proximity and the gradual relaxation of restrictions from China[38], Western Australia can expect the recent growth in Chinese tourists to continue.

2.5 Education

The provision of education services to foreigners is becoming increasingly important both nationally and at a State level. The presence of international students in Australia generated around $3.7 billion income for the Australian economy in 2000, while in Western Australia, income earned from education totalled $389 million in 1999-2000.

Growth in the number of Chinese students enrolled in Australian education providers has been particularly strong in recent years. After increasing by 68% in 1999, the number of Chinese students in Australia grew by a further 68.7% to reach around 15,000 currently. Growth in Chinese students attending Western Australian institutions has also increased at similar rates. As a consequence, China is now Western Australia's fifth largest source country for overseas students.

With the Chinese population growing in affluence, and families placing increasing importance on education as a consequence of the one child policy, demand for Australia's education services is expected to grow strongly. While the quality of educational institutions is very high, current demand for education in China simply cannot be met by domestic institutions.

35 Visitors from New Zealand (15%), Japan (14%) and the UK (13%) are still the major source countries.

36 Department of Foreign Affairs & Trade (2002) *Australia's Trade: Outcomes and Objectives Statement*, DFAT, Canberra at p123.

37 D. Murphy, "Follow the Flags To Save Tourism", Far East Economic Review, March 7 2002, p22.

38 (Even with the ADS, only residents of Beijing, Shanghai and Guangzhou are currently permitted to travel to Australia as tourists.)

The outlook for Western Australia's education providers therefore seems quite positive. Given our regional proximity and the sound reputation of our educational institutions, Western Australia should expect growth in demand for these services to continue.

3. THREATS TO WESTERN AUSTRALIA

Given the complementary nature of our trade, it is somewhat difficult to imagine that China poses any significant threats to the Western Australian economy. While China does have considerable mineral wealth, reserves of major minerals such as iron ore and alumina are limited, mainly low grade and less competitive in the international market place.

One potential risk is that the high levels of economic growth forecast by the Chinese Government may not materialise. It is quite possible that at least in the short term, China will experience some difficulties in overcoming the challenges associated with further reform and WTO accession. The Government will also need to implement further reforms to its banking sector if it is to sustain further growth. In the event that the Chinese economy does experience difficulty in implementing such reforms, it is possible that demand for Western Australia's goods and services would suffer.

4. CONCLUSION

China's macroeconomic performance and economic reform over the last two decades has been quite impressive. While China still faces some significant risks and challenges on its path to reform, the outlook for the Chinese economy remains overwhelmingly positive. Indeed, with a population approaching 1.3 billion, it has become a considerable economic power. These developments, combined with Western Australia's regional proximity to China and the striking complementarity of our two economies, have facilitated considerable export growth in recent years. With demand for our commodities exports expected to strengthen even further, China is quickly becoming an increasingly significant influence on the Western Australian economy.

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