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MICHAEL SMITH

## **The Power of Yuan** **CHINA, AUSTRALIA AND THE RMB**

We have grown used to thinking of Australia as the lucky country, perfectly placed to benefit from China's very rapid development. For the past decade and more, the Chinese government's economic focus has been on urbanisation and industrialisation, both of which require vast amounts of steel. Australia's natural endowment of both coal and iron ore are incredibly attractive to China. At the same time, China's ability to produce low-cost goods has helped to keep our domestic rates of inflation quite low even as the economy boomed. A nearly perfect trade partnership.

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It is a mistake, however, to project the future from the past. Very few people in Australia were expecting a decade ago that China would today be the world's largest trading nation, its second largest economy, and Australia's largest trade partner. Yet here we are.

We cannot know for certain what the future holds, but two significant events in March 2011 are giving us a glimpse, and one thing is fairly certain – China's near future will start to look quite different from its recent past. We need to think now about how we, as a nation, might continue to benefit from China's continued economic success.

The first event is the approval, earlier this week, by the National People's Congress of China's 12<sup>th</sup> five-year plan. The second is a much quieter event, a milestone in fact: this month, bank deposits held outside the mainland in Hong Kong and denominated in renminbi (RMB), the Chinese currency, will surpass the RMB400 billion (A\$60 billion) mark for the first time.

These two events – though separate – are intimately linked. And the implications for Australia are significant.

In its new five-year plan, China's government has clearly stated that it will become more focused on the "quality" of growth, rather than its pace. Specifically, the government is actively working to raise the standard of living for the average Chinese citizen. To do so, policymakers need to get Chinese workers to save less and buy more. They also need to get wages to rise faster, which can only happen in a sustainable way if the value-add of the manufacturing sector increases from its current low base.

This has brought the government to the twin goals of lifting both consumption and innovation. Targets in the new five-year plan include:

- Raising the minimum wage by no less than 13 per cent per annum
- Constructing and renovating 36 million apartments for low-income families
- Increasing the share of GDP contributed by the services sector by four percentage points, to 47 per cent of GDP
- Registering 3.3 patents per annum for each 10,000 head of population
- Expanding "strategic" industries such as manufacturing wind farm equipment, nuclear power equipment, metallurgical equipment and environmental protection equipment.

In addition to these targets, the Chinese government is now looking to increase the average life span of China's inhabitants by one year over the next five years. Part of this effort will include reducing pollution and cleaning up the environment: it is estimated that air pollution alone causes the premature deaths of hundreds of thousands of Chinese residents each year.

In short, China's economic model is shifting. The trend of urbanisation and industrialisation will continue; steel will still be in strong demand. However, the rate of growth in the future is unlikely to remain what it has been in the past. Rather, China's focus will be on getting more efficient around the infrastructure that it has already created, and on getting its citizens to consume more.

The link between the government's five-year targets and the accumulation of RMB-denominated deposits in the offshore RMB market in Hong Kong is critical. What the moves in Hong Kong tell us is that the Chinese government is taking active steps to internationalise the RMB, with the logical conclusion being that the RMB has finally started on the long road to becoming a fully convertible currency.

A globally convertible RMB is an important plank in realising the Chinese government's growth aspirations.

**China's near future will start to look quite different from its recent past. [In Australia] we need to think now about how we, as a nation, might continue to benefit from China's continued economic success.**

First, a convertible RMB will help households invest their savings both at home and abroad. The greater return an average citizen can earn on his savings, the less need he will feel to save. Thus, more spending.

Second, a convertible and traded currency will help China's economy to naturally balance both trade and investment flows, and smooth the business cycle – just as is currently the case with the Australian dollar, the US dollar and any other globally traded currency. This is an essential policy reform as China's economy becomes more sophisticated.

Third, a convertible currency should lead to the further development of China's local capital markets and modernisation of its monetary policy, including continued liberalisation of interest rates. This would help the Chinese government more easily control inflation – a critical issue in a period when wages are rising and demographics suggest that labour market growth will slow.

For Australian business, the mining boom – while it will continue – is no longer the only frontier for opportunity in China.

In many respects, this is great news. The focus of many economic commentators in Australia in recent years has been on the risks of a two-speed or three-speed economy. The changes underway in China represent an opportunity for other sectors of the Australian economy – our specialised manufacturing, our efficient agricultural industry, our breakthrough health and environmental products, and our services industry. It also heralds potential for a new era of investment between the two economies, in both real production and financial assets.

The demand for innovation in China gives Australia the opportunity to make good choices about our future. Our own forward-looking economic strategy needs to also be focused on innovation, with a view to extending our long economic boom and increasing prosperity for future generations. If we ignore the reality of change in China, Australia runs the risk of losing out on some of the most significant opportunities that could flow from our relationship with Asia.

Australia needs to think about finding ways to utilise its land and its water to feed a wealthier China through agricultural exports. We can sell our expertise in urban development and environmental innovation. We can create innovation goals of our own that will assist China to reach its stated target of obtaining 11.4 per cent of its primary energy consumption from non-fossil fuels. We can underwrite our own patented products that will contribute to China cutting its carbon dioxide emissions and raising its forest stock.

### **Accelerating the change**

And all of these changes will take place in the context of a major shift in the global currency markets as the RMB is increasingly traded outside of China. In many ways, the expanding use of the RMB heralds the multitude changes we will see in China in the coming years.

Most of the current discussion on the RMB focuses on its value – whether it will rise or fall against the US dollar or the Australian dollar, or how quickly.

But the real impact for Australia is not in the value of the RMB. Rather it is in the introduction to the global economy of another significant currency – potentially with a financial market that will become as large and as deep as that of Europe.

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## The Power of Yuan

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The implications of this change are enormous. It almost goes without saying that the use of the US dollar in the Asia Pacific region would fall away dramatically as the use of the RMB outside of China expands.

Companies and individuals trading in goods, services and investment will increasingly use the RMB in order to reduce their currency transaction costs and risks. With that, we would likely see a shift in preference in other Asian geographies to also use their own local currencies instead of the US dollar for trade and investment. It is a shift that is already underway, but the wider use of RMB outside of China will accelerate this development.

At the high level, this represents the decline of the US dollar standard. This is not a comment on the value of the US dollar, but rather its use as the underlying currency for most global transactions. The advent of the Euro at the end of the 20th century marked the start of the decline of the US dollar standard. The advent of a global RMB in the early part of the 21st century will accelerate this change.

For Australia, this is another important shift. At the moment, Australia punches above its weight in the global investment markets. Though Australia is the 17th largest economy in the world, the Australian dollar is the fourth most traded currency. Likewise, Australia's weighting in global share market indices benchmarks is roughly double its share of global GDP.

The main reason why Australia has such a large weighting in global trade and investment flows is because so much of the large Asian markets – by virtue of capital and currency controls – has been inaccessible to global investors. Australia has been a proxy for investment in Asia.

As the RMB and other local currencies and markets become increasingly open to global investment, Australia's share of the pie will shrink. The task for us will be to create an investment opportunity so compelling – based on our natural assets, innovation, our drive and our results – that investment into Australia from Asia and the rest of the world will continue to flow in the years to come.

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