Markets Research

Macro-Thematic

national australia bank

Thematic – China's economic evolution and implications for the Australian economy

Summary

China is by far Australia's largest trading partner and Australia's economy remains sensitive to Chinese growth prospects. However, resources exports have not been a driver of growth in the Australian economy in recent years and the direct link from Chinese growth to resource demand is likely to remain much weaker than through the mining boom. Even so, Australian mining profits (and household wealth) and government revenues remain sensitive to commodity prices.

On balance, it is likely that Trump's electoral victory presents additional downward pressure to China's growth in the next few years (depending on various policy responses in both the US and China), with the impact on Australia coming through the trade channels identified above.

Key points

- China is Australia's largest export market, accounting for 32.5% of all exports in 2023, equivalent to 8.4% of nominal GDP. At $115.6b, iron ore accounts for around half of all exports to China, followed by LNG ($20.4b), education-related travel ($11.4b) and coal ($9.2b).
- COVID-era disruptions aside, key commodity export volumes have been broadly stable since before the pandemic. As a result, commodity exports have been a modest drag on real GDP growth and, in the absence of a new investment boom, are unlikely to drive growth in the near term.
- Further slowing in Chinese construction activity presents a downside risk to commodity export volumes, but the impact would depend on the extent of the shift in demand and Australian producer's position in the cost curve. Australian iron ore makes up around two-thirds of Chinese imports.
- An important transmission mechanism of slower growth in China to Australia's economy would come via commodity prices, that flow through mining sector profits (and household wealth) and government revenues.
- These linkages are especially important in the wake of the US election. Any material escalation in US trade barriers will have a larger impact on Australia via our connections to China rather than direct exposure to the US.

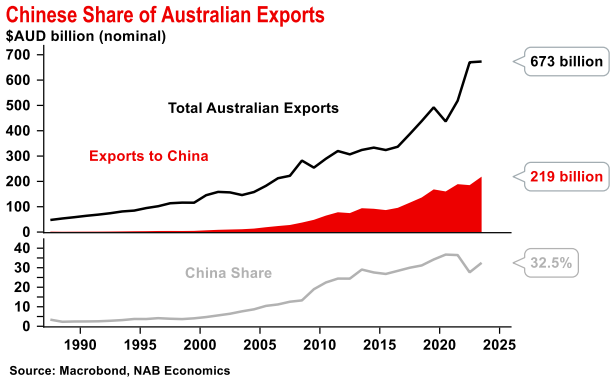
Details

The linkages from China to Australia's economy are primarily via trade, with China accounting for a third of all Australian exports.

China's rapid industrialisation over the past few decades has increased the trade ties between the two countries. Australian goods and services exports to China totalled $219 billion in 2023, equivalent to 32.5% of total exports, making it by far Australia's largest export destination.

Trade has been dominated by the raw materials needed to fuel China's industrial sector, led by iron ore exports, which totalled $116b in 2023 – equivalent to 53% of total exports to China and 17% of Australia's total goods and services exports. Other key commodity exports to China include LNG ($20b in 2023) and coal ($9b).

The steel industry has been central to China's economic development. Steel output totalled 1.0 billion tonnes in 2023, over four and a half times the level of output in 2003. Just under one-third of Australia's iron ore exports were shipped to China in 2003; this share rose to 85% in 2023.



Source: Macrobond, NAB Economics

Increasing household wealth in China has also driven dietary change, boosting demand for agricultural exports such as beef, and increased consumption of services. In fact, services now make up a significant component of Australia's exports to China, totalling $15b in 2023. These are primarily in the form of education exports (the tuition fees and spending by Chinese international students in Australia) and tourism.

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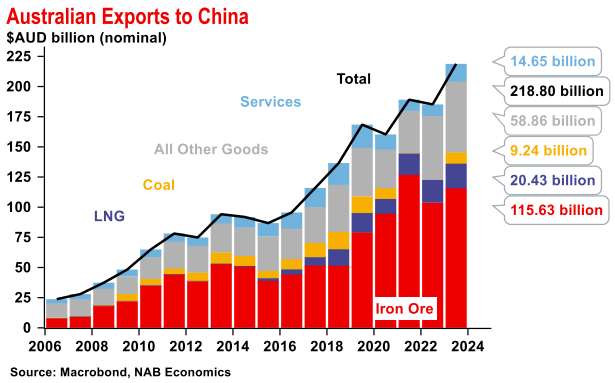
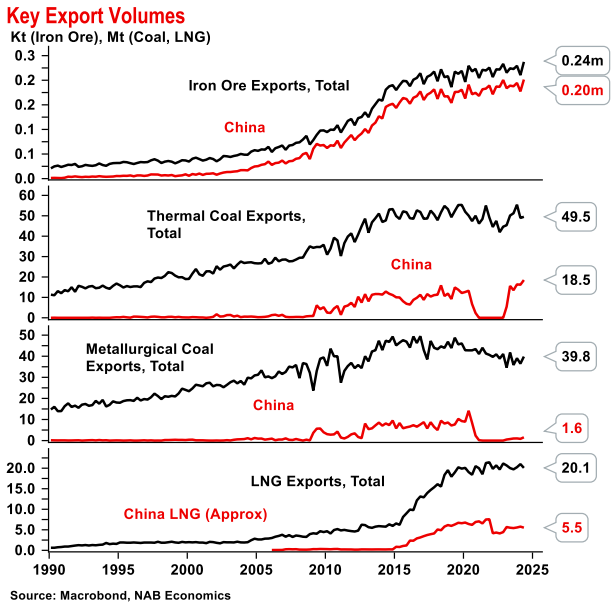


While nominal trade values fluctuate due to commodity prices, underlying export volumes for key commodities have been surprisingly stable.

After increasing rapidly through the 2000s and early 2010s as the 'mining boom' expanded production and port capacity, iron ore export volumes have increased only gradually in the past 5-7 years. Coal and LNG exports volumes have been broadly stable in the post-mining boom period.

More recently, trade barriers temporarily interrupted exports of coal to China but this had little impact on overall thermal coal exports, suggesting Australian producers found alternative markets during the period of disruption. Thermal coal exports to China have since recovered to their previous levels.

In contrast, metallurgical coal exports to China have remained subdued. While this has not driven a sharp drop in overall met coal export volumes, there is a broader gradual downward trend which may reflect a range of factors including the emerging use of electric arc furnaces in steel production.

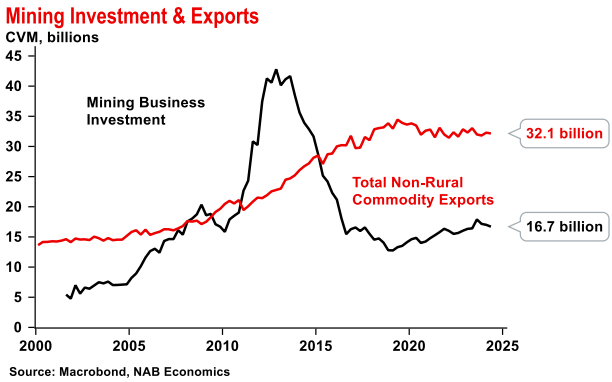


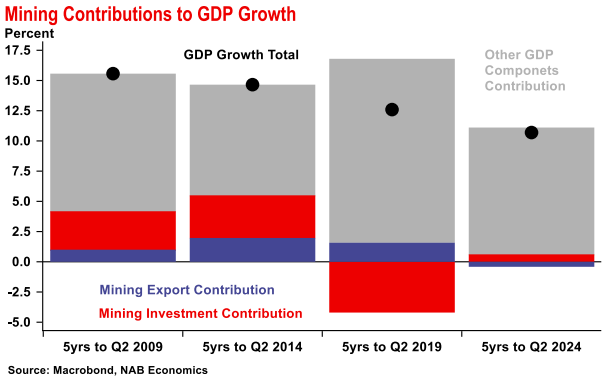
The broadly stable volume of these key exports – through a period of significant disruption to the Chinese and global economies – suggests underlying export volumes have been largely dictated by Australian production capacity rather than shifting levels of demand for commodities from China or elsewhere.

Capacity constraints have seen mining exports become a modest drag on GDP growth, and there is no sign of a new investment boom to drive growth.

Increasing mining export volumes helped drive Australia's real GDP growth through the decade prior to COVID, contributing 1.6ppts to total GDP growth (15.2%) in the five years to mid-2019. However, in the five years to Q2 2024 this effect has reversed, with mining exports subtracting 0.4ppts from the total (10.5%).

There has also only been a very modest increase in mining business investment volumes from their post-boom lows, contributing 0.6ppts to total growth over the past five years. At this stage, this is unlikely to be sufficient to generate a significant expansion in mining production capacity, meaning that commodity exports to China or elsewhere are unlikely to become a major driver of GDP growth again in the near term.



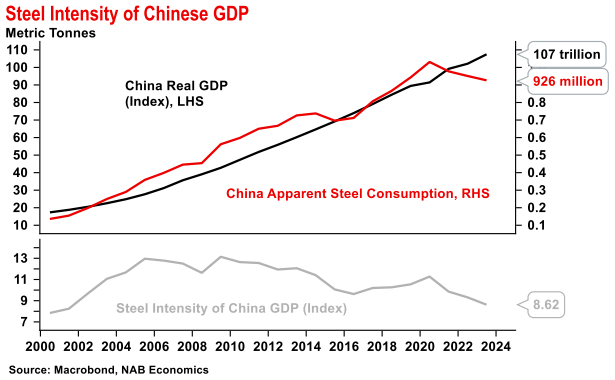


Slowing Chinese construction activity could translate into weaker iron ore demand – but the extent to which Australian export volumes would be affected is difficult to know.

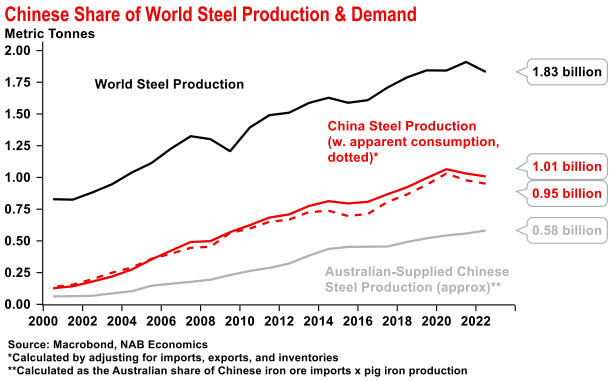
China's recovery from the COVID-19 pandemic has been relatively subdued (when compared with trends in advanced economies), failing to see a strong rebound in consumption when pandemic restrictions were removed. A lack of fiscal support for households (with China's government choosing to support firms instead), the fallout from the severe property downturn, and regulatory crackdowns on private sector firms (most notably in the technology sector) have negatively impacted domestic demand.

Demographics have also become an increasing drag on activity – with the working age population in decline for over a decade, and the total population contracting the past two years. The experience of both Japan and South Korea shows it becomes more difficult to sustain economic growth as a country's population starts to decline, meaning that this is likely to become a growing issue for China over the longer term.

For Australian iron ore exports, conditions in China's construction (residential, non-residential and infrastructure) sector are a key determinant of steel demand. In 2018, prior to the downturn in China's housing sector, studies[1] suggested that construction accounted for around 59% of steel demand. More recent estimates by BHP[2] suggest this share fell to 41% in 2023, with some of this decline offset by stronger machinery manufacturing and steel exports – albeit it is not clear that this growth could be sustained given growing trade tensions. Despite Chinese authorities stating their goal to stabilise the property sector, we argue that the current downturn in construction likely has further to run, given the sizeable overhang of vacant properties. Where construction activity ultimately settles in the longer term is uncertain, however it will not be at the pre-2020 peaks, given China's population is now in decline.



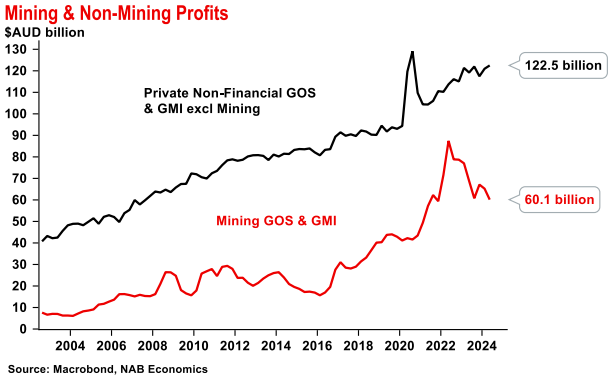
That said, weaker steel demand does not directly mean lower iron ore exports from Australia. Australia supplies around two-thirds of China's iron ore imports. As such, whether the volume of Australia-China iron ore trade would be affected by a reduction in Chinese steel consumption would depend on a range of factors, including the extent of the fall in demand, the position of Australian iron ore on the cost curve relative to other suppliers, and whether there are offsetting increases in steel demand from other developing countries that could be export destinations for Chinese steel.



Even if trade volumes are stable, Chinese activity will continue to affect Australia's economy through commodity prices, profits and government revenues.

As the largest consumer of most non-rural commodities (with the notable exception of crude oil, where the United States remains the biggest market), changes in China's demand can have a major influence on commodity prices. There has been notable volatility in a number of markets this year – including iron ore and base metals – in response to rumours of imminent Chinese stimulus that markets expected would boost demand.

For Australia, these movements in commodity prices have driven large shifts in mining profits and by extension nominal GDP, with non-mining profits growing in a much more stable manner over time (with the exception of COVID). A further easing in commodity prices from here would see a significant drag on the terms of trade and nominal GDP measures even if underlying activity growth is positive.



Commodity prices flow through to government revenues primarily through royalties (paid to the states) and corporate tax revenue (to the Commonwealth). ABS data indicates iron ore producers paid around $11b in royalties to Western Australia in 2022-23 (equivalent to 2.4% of gross state product), while coal royalties in Queensland

[1] Honghua Yang et al. 2023.Tracing China's steel use from steel flows in the production system to steel footprints in the consumption system. Renewable and Sustainable Energy Reviews, Volume 172. https://doi.org/10.1016/j.rser.2022.113040.

[2] https://www.bhp.com/news/bhp-insights/2024/07/visualised-chinas-steel-demand-through-time

totalled around $18b (3.6% of GSP), contributing to budget surpluses in both states.

The impact of commodities prices on corporate tax revenue has also contributed to the Federal Budget being in surplus in 2022-23 and 2023-24. The federal government also stands to benefit from LNG prices via the Petroleum Resource Rent Tax (PRRT) – though revenue from this tax has been limited to date.

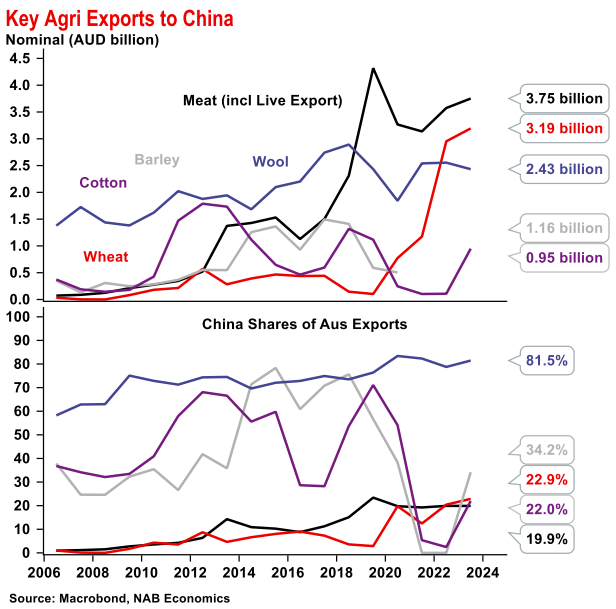
The most recent Federal Budget maintained the longstanding practice of assuming commodity prices return to historical levels, with the iron ore spot price assumed to decline to US$60/tonne, the metallurgical coal spot price to US$140/tonne, and the thermal coal spot price to US$70/tonne, while the LNG spot price was assumed to converge to US$10/mmbtu. This means that projections for the budget position already factor in a substantial softening in Chinese iron ore demand flowing through to prices.

Indeed, iron ore prices have so far held up well above the budget's assumptions and NAB sees the likely anchor point in 2025 as more in the range of US$80-$90/tonne. Sensitivity analysis in the most recent Federal Budget suggested that a $10/tonne increase in iron ore prices relative to the budget's forecast assumptions would increase revenue by between $500 million and $1.9 billion per year over the forecast period.

Australia's agricultural exports to China are relatively smaller than industrial commodities, and are unlikely to be as closely affected by China's growth outlook.

Combined meat exports are Australia's largest agricultural commodity export to China and have risen steadily as the Chinese population has grown and become relatively wealthier – leading to changes in the dietary composition towards protein. Wheat was the next largest agricultural export to China in 2023 but largely due to elevated prices. In both cases, China makes up less than a quarter of all Australian exports.

China is also a key market for Australian wool, accounting for around 80% of total wool exports. In this case, the outlook is more dictated by global growth and demand for wool products, rather than Chinese economic growth.

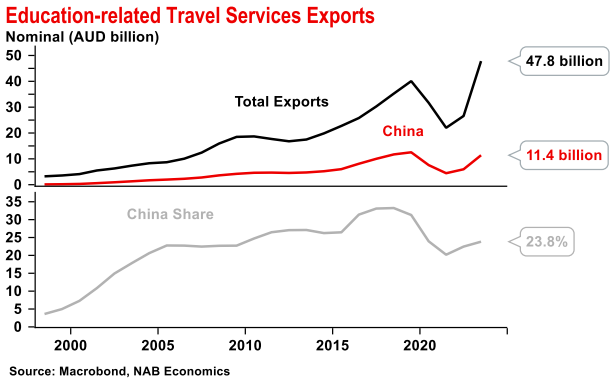


Source: Macrobond, NAB Economics

Services exports to China are substantial but have not yet fully recovered from COVID-related disruptions, leaving some upside even in the context of slowing Chinese growth.

Education-related travel exports to China (Chinese students studying in Australia) had risen rapidly in the decade prior to COVID and reached around a third of all education exports before the pandemic hit. This reflected the rising wealth of the Chinese population and Australia's high standing and relative proximity as an education destination.

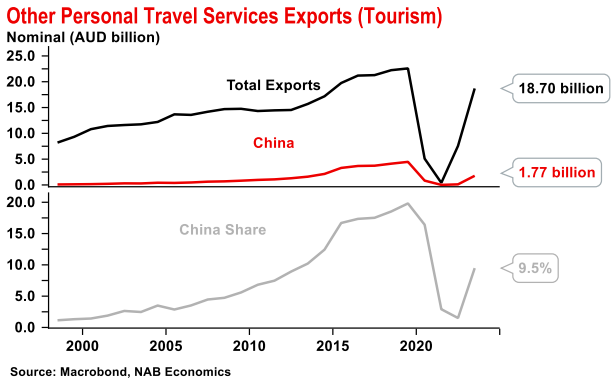
Since the end of pandemic-related travel restrictions, overall education related exports have surpassed their pre-COVID level in nominal terms, but exports to China have lagged. How this recovery progresses will likely depend more on policy arrangements, both in China and Australia, than China's economic performance.



Source: Macrobond, NAB Economics

In terms of tourism exports, the story is similar with rising Chinese wealth supporting increased personal travel, with China accounting for around 20% of all tourism exports by value prior to the COVID-19 pandemic. As with education, the rebound in Chinese tourism to Australia since borders reopened has been partial and slower than the wider rebound in the sector. A stabilisation in Chinese household wealth may be an important precursor to a further recovery in tourism to Australia, as is the diplomatic

relationship between the two countries. China's government has actively discouraged travel to other countries during periods of dispute – such as to South Korea in 2017.



Outside of exports, there are also linkages between Australia and China via imports, foreign investment and currency movements.

Australia's imports from China primarily consist of manufactured goods – reflecting China's dominant role in global manufacturing. This is particularly in electronics and increasingly in motor vehicles, given that China is major producer of electric vehicles. While some multinational firms have sought to reduce China's role in global supply chains, it is likely to remain a critical producer regardless of slower economic growth.

China's foreign investment in Australia surged between 2005 and 2013, with data from the American Enterprise Institute suggesting that Australia was the leading recipient of Chinese investment over this period. This primarily reflected investment in the resources sector. However, from 2013 onwards, Chinese investment in Australia slowed significantly, with investment funds directed elsewhere. ABS data shows that China held the tenth largest stock of foreign investment in Australia in 2023, totalling around $88 billion, however this is dwarfed by investment by the United States and United Kingdom, whose stock of investment were over 13 times and 10 times larger respectively. This suggests that should a slowdown in China's growth result in a shift in its foreign investment holdings, this would not have a significant impact on Australian economic activity.

Australian investment in China is relatively modest and has declined since the COVID-19 pandemic, with China's share of total investment falling from around 3% in 2019 to 1.5% in 2023.

APRA data suggest that Australian financial institutions' exposure to China is a small share of total exposures, and similarly there is limited lending by Chinese banks in Australia, meaning there is limited risk of a financial crisis in Australia associated with slowing Chinese growth.

China has an influence on the value of the Australian dollar as well. Movements in commodity prices – which are driven in part by the strength of China's demand – directly impact the value of the currency (albeit this is just one factor among others that has influence). In addition, since the start of the mining boom, foreign investors have used the Australian dollar as a low risk proxy for investment in China – given the close trade relationship. Slower growth in China could place downward pressure on the Australian dollar through both of these channels.

Beyond the direct linkages between China and Australia, China's economic growth over the past two decades has had a broadly positive influence on activity in the rest of East Asia (albeit to different degrees in individual countries), with trade being the main driver. This region is also important for Australian trade – Japan remains Australia's second largest market for goods & services exports (accounting for 13.4% of the total in 2023) with South Korea third (6.5%) while the combined ASEAN economies accounted for 12.9% of the total. Negative spillover effects from slower growth in China could indirectly impact demand for Australian goods and services in East Asia.

Conclusion

China's economic growth prospects are constrained by near term factors – such as the fallout from its property downturn and weak domestic demand – and its longer term demographic drag. That said, near term growth could be boosted by fiscal stimulus measures expected to be announced following the National People's Congress scheduled for 4-8 November. The scale and direction of this spending will be important factors in determining the success of any such measures, however we argue that the best outcome from fiscal stimulus would be to put China's economy on a more sustainable footing (reducing the scale of imbalances within its economy) as it transitions to a slower long term growth trajectory.

In isolation, the incoming Trump Administration's tariff proposals are a negative for China's growth prospects, however the impact on China's economy will depend on the scale of tariffs (as we noted in our US election note it is possible that tariffs could be smaller than those proposed during the campaign), China's trade policy response (with retaliatory tariffs in 2018 triggering the full scale trade war between the US and China) and whether China will step up fiscal stimulus to the domestic economy to counter the negative pressures of US trade policies. On balance, it is likely that Trump's electoral victory presents additional downward pressure to China's growth in the next few years, with the impact on Australia coming through the trade channels identified earlier in this note.

Given that trade is the primary linkage between the Chinese and Australian economies, we find that the main impact of any slowing in China's growth would be via Australian exports, where weaker commodity prices would reduce the profits of exporters (and by extension, the household wealth of their shareholders) and the revenue of governments. Other linkages are less likely to be impacted.

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