CHINA AND THE AUSTRALIAN DOLLAR

Address to a dinner hosted by the
Australia-Japan Roundtable

Residence of Mr Shisei Kaku,
Consul-General of Japan to Victoria
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Thank you for your hospitality and for the honour of being the guest speaker at the first Australia-Japan Roundtable Dinner in Melbourne. I know from Manuel Panagiotopoulos of Australian and Japanese Economic Intelligence that this has been a very successful forum in Sydney and I hope that it will also turn out to be so in Melbourne.

I've had the pleasure of knowing the past three Consuls-General of Japan to Victoria – all of whom have been wonderful servants of their country and who have done a great job in promoting economic, cultural and social links between Victoria and Japan, and I am confident that Kaku-san will be a very worthy successor to Urabe-san, Ueno-san and Miyashita-san.

In some ways it's a little strange to be talking here tonight at the home of the Consul-General of Japan about China. I say that because there are now such interesting things happening right now in Japan.

Yesterday we saw the calling of a snap election following the defeat of Prime Minister Koizumi's legislation enabling the privatization of Japan Post in the Upper House of the Diet. I greatly admire Mr Koizumi for honouring his pledge to seek a renewed mandate for reform from the Japanese people in the event of this legislation being defeated. I can think of only one other leader of a government who went to an election seeking a mandate to privatize his government's largest asset, and that was former Premier Tony Rundle of Tasmania in 1998. He lost. Mr Koizumi is thus certainly being courageous, in the sense intended by the legendary Sir Humphrey Appleby. I wish Mr Koizumi well.

The other interesting development in Japan is the growing evidence that after more than a decade of stagnation, punctuated by three recessions, the economy may be entering a period of sustainable economic growth. We learnt last Friday that in June Japan's unemployment rate fell to 4.2%, the lowest in nearly seven years, and that the ratio of job offers to job applicants rose to 96%, its highest since 1992. There are signs that land prices, after falling by over 80% from their bubble-economy peak in late 1989, are beginning to rise again, at least in Tokyo. For the last four quarters, consumer confidence has been at its highest level since 1996. Business confidence is improving. And all of this is happening while export growth has been slowing, the current account surplus has been shrinking, and public works expenditure has been declining – to the point where it now accounts for less than half the share of GDP it did nine years ago.

I could say more about this, but I have been asked to talk about China and the Australian dollar, so out of respect to our hosts, let me now do that.

Last week *The Economist* magazine stated that "China is behind almost everything … going on in the world economy"[1]. *The Economist* is occasionally given to sweeping generalizations which turn out to be wrong – they have been doing that a lot in relation to housing markets, for example, in recent years – but in this particular instance they have, I think, summarized the situation quite neatly.

The emergence of China as a significant influence in the world economy and in world markets for tradeable goods and services, commodities, labour and financial assets is, arguably, the most significant change in global macro-economics since the breakdown of the Bretton Woods currency system in the early 1970s.

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[1] "From T-shirts to T-bonds", 30 July 2005, p. 65.

Over the past decade, China's economy has expanded at an average annual rate of 8.4%, a pace exceeded by only six other countries in the IMF's universe of 180 countries[2].

This is rapid by historical standards, but it is by no means unprecedented for economies at China's stage of economic development. For example Japan's economy grew at an average annual rate of 8.8% in the 1950s and 10.5% in the 1960s; West Germany grew by 8.2% per annum in the 1950s; Spain at an 8.6% annual rate in the 1960s; Hong Kong at annual rates of 6.9%, 8.9% and 9.0% in the 1950s, 60s and 70s, respectively; South Korea at annual rates of 8.7%, 9.6% and 9.1% in the 1960s, 70s and 80s, respectively; Taiwan at annual rates of 8.5%, 10.0% and 9.2% in the 1950s, 60s and 70s, respectively; Singapore at annual rates of 9.2%, 9.0%, 7.1% and 7.7% in the decades from the 1950s through the 1990s; Israel at annual rates of 10.7% and 8.9% in the 1950s and 60s; Iran at a 10.0% annual rate in the 1960s; Brazil at an 8.1% annual rate during the 1970s; and more recently, Ireland and Vietnam at annual rates of 7.2% and 7.6%, respectively, in the 1990s[3].

Of course in many cases these growth rates were in part driven by faster rates of population growth than in China over the past decade; and in other cases rapid economic growth entailed levels of borrowing which eventually proved unsustainable. However, even in per capita terms, China's impressive growth rate of 6.9% over the past decade has been exceeded by Japan and West Germany in the 1950s; Japan, Greece, Spain and Taiwan in the 1960s; South Korea, Taiwan and Singapore in the 1970s; and by South Korea in the 1980s.

China is the world's sixth largest economy measured by GDP converted to US dollars at market exchange rates. Converted to US dollars at purchasing power parities, which as the System of National Accounts emphasizes is the more appropriate measure "when the objective is to compare the volume of goods and services produced or consumed per head"[4], China is the second-largest economy in the world, having overtaken France in 1984, Russia in 1985, Germany in 1987 and Japan in 1995.

If the long-term consensus projections compiled by Consensus Economics earlier this year are vindicated, by the year 2015 China will have (just) overtaken the United States as the world's largest economy. These projections are set out in Table 1. Of course, these projections may prove inaccurate: by and large they extrapolate the growth rates of the recent past, and make no allowance for a global economic downturn, or for downturns in any individual economy, and they do not seem to make much allowance for demographic factors (on which see more below). On the other hand, as noted earlier, the growth rate projected for China has been sustained by other countries for long periods. Whatever its precise growth rates over the next decade, China will still be a relatively poor country in 2015, despite its size. On the projections given in Table 1, China's per capita GDP will be barely more than one-fifth that of the US (cf. about one-seventh in 2004) and slightly less than one-third of Japan's (cf. a little over one-sixth in 2004).

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[2] Those being, according to the IMF, Equatorial Guinea, Bosnia and Herzegovina, Azerbaijan, Qatar, Turkmenistan (!) and Burma (!!).
[3] The growth rates in this paragraph are calculated from estimates of real GDP in 1990 US$ compiled by the Groningen Growth and Development Centre (at the University of Groningen in the Netherlands) and available on-line at Hhttp://www.ggdc.net/H.
[4] United Nations et al, *System of National Accounts 1993*, paragraph 1.38. See Ian Castles and David Henderson, "International Comparisons of GDP: Issues of Theory and Practice", *World Economics* Vol 6, No 1 (January-March 2005), pp. 55-84, for a discussion of the issues involved in international comparisons of GDP.

Table 1: Actual and projected GDP in US$ at 2005 PPPs, 2005 and 2015

	GDP - 2005		Projected growth rate, 2005-2015	*GDP – 2015(f)*	
	US$ bn	*Rank*		*US$bn*	*Rank*
United States	12,332	1	3.2	16,950	2
China	8,092	2	8.0	17,533	1
Japan	4,009	3	1.5	4,662	4
India	3,603	4	6.9	7,015	3
Germany	2,499	5	1.5	2,897	5
United Kingdom	1,826	6	2.1	2,250	=7
France	1,812	7	2.1	2,239	9
Italy	1,695	8	1.6	1,978	10
Russia	1,586	9	5.0	2,585	6
Brazil	1,553	10	3.8	2,252	=7
Canada	1,112	11	2.7	1,448	14
Korea	1,099	12	4.5	1,702	11
Mexico	1,065	13	3.7	1,537	=12
Spain	1,026	14	2.8	1,422	15
Indonesia	864	15	6.0	1,543	=12

Sources: IMF, *World Economic Outlook* database, April 2005; Consensus Economics, *Consensus Forecasts* (and sister publications), April 2005 (March 2005 for Russia); author's calculations.

From a long-term perspective, the prospect of China becoming the world's largest economy within the next 10-15 years, represents a return to the order which has prevailed throughout most of human history. According to calculations by Angus Maddison, from at least the beginning of the common era until the early 19th century, China or India were the world's largest economies. This is actually unsurprising when you recall that for much of this period China and India were intact polities, had the world's largest populations and were technological leaders.

As Jared Diamond notes, "until around AD 1450, China was technologically much more innovative and advanced than Europe"[5]. Chinese inventions before or during this period included the wheelbarrow, gunpowder, matches, cast iron, porcelain, magnetic compasses, sternpost rudders, paper, printing, paper money and a meritocratic civil service.[6]

The decline in the relative importance of China between the early 18th and late 20th centuries resulted from, *inter alia*, the industrial revolution in Western Europe; the formation and rapid expansion of the United States; China's retreat from engagement with the global economy beginning during the Ming Dynasty[7] and subsequent decay under the Qing; the impact of 'gunboat diplomacy' and 'unequal treaties'; and nearly fifty years of warfare and social disorder in China in the first half of the 20th century followed by another quarter-century of chaos and misrule under Mao Zedong.

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[5] Jared Diamond, *Guns, Germs and Steel* (Vintage, London, 1998), p. 253.

[6] Diamond, *ibid;* see also Robert Temple, *The Genius of China: 3,000 Years of Science, Discovery and Invention* (Simon and Schuster, New York, 1986).

[7] See, for example, Gavin Menzies, *1421: The Year China Discovered the World* (Bantam Books, London, 2002), which argues (not uncontroversially) that Chinese explorers reached the Americas before Columbus and Australia before De Vlaminck, Dampier, Tasman, Cook et al. These voyages were stopped by officials who opposed trade and foreign contact on principle. Ming and Qing China arguably constitute an early example of the folly of turning one's back on globalization.

Against this background, the 'emergence' of China can be seen as a reversion to a more 'natural' state of affairs, which has been made possible by the implementation of more stability-oriented and growth-friendly macro-economic policies and by far-reaching micro-economic reforms (as well as a wide range of social and other policy changes), beginning in 1979.

Among the things which China has 'got right' from a development perspective are:

- saving and investing upwards of 35% of GDP
- achieving relatively high literacy rates, with little difference between men and women, and favourable health outcomes (infant mortality, life expectancy) compared with other countries having similar (or in many cases higher) per capita GDPs
- integrating itself with the global economy, and
- attracting foreign direct investment, including into sectors which other developing countries have kept closed to foreign investors

China has found it easier to implement 'good economic policy' in part because it has been, and remains, a one-party dictatorship that can in most cases ignore or over-ride public opinion; because it is except for some outlying areas) essentially a mono-cultural society with a single national language and no strong religious beliefs; and that it has a long tradition of strong central government. In each of these respects China has a significant advantage over India, for example.

However China's achievement of rapid rates of economic growth on the basis of (inter alia) high rates of investment is not an unalloyed blessing. China's incremental capital-output ratio or ICOR (defined as the ratio of the investment share of GDP to the growth rate) has averaged 4.2 over the decade ended 2004 (ie, it has required investment equivalent to 4.2% of GDP to boost real GDP growth by one percentage point); over the last five years China's ICOR has averaged 4.8%.

These ratios are much higher than the corresponding periods for other economies during periods of rapid growth, for example 3.2 for Japan in the 1960s, and with 3.2 and 2.7 for South Korea and Taiwan in the 1980s, respectively[8].

The implication is that capital is being allocated inefficiently in China, and, moreover, that the efficiency with which capital is being allocated is declining. The overwhelming majority of Chinese investment capital is provided by loans, particularly from State-owned banks, which until the late 1980s provided credit in accordance with centrally-determined plans rather than according to normal banking criteria. There has been little 'market discipline' over the allocation of capital in China.

China also confronts a serious demographic challenge. Largely as a result of the 'one-child' policy, China's population has a median age of 33. 7.6% of China's population is aged 65 or over; these will rise to 13.7% by 2025. China's working age (15-65) population will peak at just over 1 bn around 2015, and decline by 15mn over the next ten years, and by a further 141 mn over the following 25 years.

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[8] Chi Hung Kwan, "Why China's Investment Efficiency is Low – Financial Reforms are Lagging Behind", Japan Research Institute of Economy, Trade and Industry, *China in Transition,* 24 June 2004 (Hhttp://www.rieti.go.jp/en/china/04061801.htmlH).

As Jonathon Anderson of UBS points out, China "faces developed-country demographics [and] developed-country social liabilities … at a per capita income level of only slightly more than US$1,000"[9].

One of the most important ways in which China is reshaping the global economy is via its impact on the prices of tradeable goods.

China's merchandise exports have grown at an average annual rate of 13% per annum since 1981 (in US$ at market exchange rates), and by 18% per annum since 1991. As a share of the world total, China's merchandise exports have risen from 1.1% in 1981 to 6.8% in 2005 (or to 10.5% of world exports excluding intra-EU and NAFTA trade); last year China became the world's third largest exporter, after Germany and the United States. If the growth rates of the past decade are sustained, China will overtake the US in 2007 and Germany in 2009.

China's merchandise imports have likewise grown rapidly, at an average annual rate of 15% since 1981: with 6.1% of the world total China is also now the world's third-largest importer[10]

As a generalization, China is pushing up the prices of the goods which it imports – mainly commodities; and pushing down the prices of the goods which it exports – mainly manufactured goods.

Thus, for example, China's oil consumption has risen by 2.2mn barrels per day over the past five years (a growth rate of 8.6% per annum), accounting for 38.4% of the increase in global oil consumption and absorbing 28.6% of the increase in world oil production over this period. Yet China's oil consumption is still relatively low – 0.91 bpd per U$1mn of GDP (cf 1.39 for Japan and 1.77 for the US), or 1.8 bpd per person – and is likely to continue growing at a rapid pace.

China's impact on the global coal trade has been even more striking. China is the world's largest coal user by a wide margin; rapidly increasing electricity generation has seen its coal consumption rise at an average annual rate of 14.2% over the past five years, accounting for 70% of the increase in global consumption over this period. Although China also exports thermal coal, its imports (mainly of higher-quality coals) have increased more than four-fold over the past five years (albeit from a very low base).

It thus seems almost unarguable that the demand for energy to fuel China's rapid industrialization and growth has been an important, if not the most important contributor to the sharp rise in energy prices over the past few years: and that this effect will continue to be felt for many years to come.

China's rapid industrialization has also had a significant impact on the markets for a range of other metals and minerals. For example China is now producing close to 300Mt of steel annually, double the amount in 2001, and nearly three times as much as Japan. China has thus emerged as a major source of demand for iron ore and metallurgical (coking) coal. China is the world's largest producer of iron ore, but its production has a low Fe content: China's imports of iron ore have risen at an average annual rate of 30% over the past five years, accounting for over 85% of the increase in global iron ore trade.

[9] Jonathon Anderson, "How to Think About China (Part 2)", *Asian Economic Perspectives*, (UBS Investment Research, Hong Kong, 7 February 2005), p. 17.
[10] Statistics in this section are sourced from IMF, *Direction of Trade Statistics,* unless otherwise noted.

Similarly, although China is a large producer of coking coal, the quality is poor, and Chinese imports of coking coal have jumped sharply from less than 0.5Mt pa prior to 2003 to 6.8Mt in 2004. Although this represents only 3% of total world trade in coking coal, China has accounted for one-third of the increase in coking coal trade over the past two years. Against a background of very tight supplies, Chinese demand has been a key contributor to the more than doubling of coking coal prices over the past 12 months.

China's consumption of nickel has also trebled over the past five years, vaulting past Germany and the US to become the world's second largest consumer (after Japan) and accounting for 55% of the increase in global nickel use during this period.

China's demand for copper has risen 75% over the past five years, more than accounting for the entire increase in global demand (copper usage in the United States, which was the world's largest copper user until overtaken by China in 2001, has fallen by more than 12% over this period).

However, where China is, or has become, a significant net exporter of commodities the impact on prices has been rather different.

Aluminium provides perhaps the best illustration of this point. In 2004 China overtook the US as the world's largest primary consumer of aluminium; growth in Chinese demand has accounted for half the increase in global primary aluminium consumption over the past five years. In this case, however, Chinese aluminium production has risen at an even faster rate (20% pa over the past five years) than consumption (16% pa), so that China has been a net exporter of aluminium since 2002; in 2004 its net exports totalled 646,000 tonnes, as against net imports of 705,000 tonnes in 2000.

Thus aluminium prices have risen by 'only' 44% over the past four years – and have actually fallen since March this year – whereas prices of copper, nickel, and lead have risen by over 100% over the past four years. China is also becoming a more significant producer of refined zinc, and thus it is no surprise that zinc prices have risen much less than prices of other base metals (apart from aluminium). China's emergence towards the end of last year as a net exporter of steel products such as coil and wire has likewise exerted a significant downward effect on the prices of these products in 2005.

One of the most striking aspects of the current phase of rising commodity prices is that – in marked contrast to those of the mid- and late 1970s, for example – higher commodity prices have not led to rising prices for finished goods, and hence have not been reflected in higher inflation.

China provides part of the explanation for this, too, via its effect on the prices of an increasing range of tradeable 'finished goods' ranging from textiles, clothing and footwear (which now account for less than one-sixth of total Chinese exports), toys and sporting equipment (less than one twenty-fifth of total exports) to whitegoods and auto parts (of which China has become a net exporter for the first time this year).

A study by Dresdner Kleinwort Wasserstein, quoted in *The Economist* article I mentioned earlier, suggests that China has lowered America's inflation rate by almost a full percentage point in recent years.

In short, what China is doing is changing *relative* prices.

And it is changing relative prices in a way that is particularly beneficial to Australia. In simple terms, China is a net importer of (non-agricultural) commodities, and a net exporter of manufactured goods. Australia is the opposite: a net exporter of commodities, and a net importer of manufactured goods.

Indeed Australia is one of the few countries in the world whose principal exports are not at risk of being priced out of global markets by China – since China cannot conjure up reserves of coal, iron ore, nickel, natural gas etc. which it does not have. And we are also one of the few countries in the world which has little to lose from China's growing dominance of markets for the products which it can now or will eventually produce – since (with a couple of exceptions) we have (to our very great benefit) exited those industries through our own program of unilateral trade liberalization.

It is thus no co-incidence that China's emergence as a significant influence on the global economy has been paralleled by a dramatic reversal in Australia's terms of trade – that is, the ratio of the prices we receive per unit of our exports to the prices we pay per unit of our imports. Australia's terms of trade declined for most of the 20th century: together with our own economic mis-management this decline was a major reason for Australian living standards falling from about the highest in the world at the beginning of the 20th century to around 19th by 1990.

Over the past ten years, however, the average unit price of Australia's exports has risen by 19% in US$ terms (ie, abstracting from fluctuations in the value of the A$), while average unit price of our imports has fallen by 8% in US$. As a result, over the past decade Australia's terms of trade have improved by almost 30%, to their most favourable since the September quarter of 1974 – and this is before the sharp rises in coking coal and iron ore prices which came into effect on 1 April have been reflected in the published data.
Together with the dramatic improvement in the quality of Australian economic management since the mid-1980s this improvement in the terms of trade has contributed to a recovery in Australians' standard of living from 19th in 1990 to 8th in 2004[11].

Given the long-term relationship between Australia's terms of trade and its exchange rate, the emergence of China as a key influence on the relative prices of globally traded goods can thus also be said to have been a major contributor to the recovery in the value of the Australian dollar from its lows of 2000 and 2001.

Indeed – as the Governor of the Reserve Bank pointed out in a speech in June - if anything, the A$ has over this period risen by less than one might have expected given the improvement in the terms of trade over this period, especially considering that for most of this period there was also a significant interest rate premium in favour of Australia[12]. This may represent evidence that the financial markets are concerned about the fact that – as on previous occasions when our terms of trade have been moving in an ostensibly favourable direction – Australia is again running a very large current account deficit.

China's impact on the Australian dollar is of course just one aspect – and a very small one at that – of its growing influence on global financial markets.

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[11] Data on relative standards of living derived from estimates of real GDP in 1990 US$ compiled by the Groningen Growth and Development Centre (at the University of Groningen in the Netherlands) and available on-line at Hhttp://www.ggdc.net/H.

[12] Ian Macfarlane, *Global Influences on the Australian Economy*, Talk to the Australian Institute of Company Directors, 14 June 2005; available on the Reserve Bank's website at Hhttp://www.rba.gov.au/Speeches/2005/sp_gov_140605.htmlH .

Until 2003, China's current account surpluses were typically quite small, averaging less than 2% of GDP between 1990 and 2002 and exceeding 3% of GDP (at market exchange rates) in only four years. Over the past two years, however, China's current account surplus has mushroomed, reaching US$70bn (4.2% of GDP) in 2004 and on track to exceed $100bn (5% of GDP) this year.

On top of this China has attracted a large and growing volume of foreign direct investment – exceeding US$50bn per annum in recent years – and, more recently, a rising tide of portfolio and other capital inflows, which topped US$56bn in 2004. A good deal of the latter appears to have been driven by market expectations of an imminent revaluation of the renminbi.

A country running a large current account surplus and attracting significant net private capital inflows under a flexible exchange rate regime would almost certainly see its exchange rate appreciate. Of course China maintained a fixed exchange rate regime from 1994 (something which served as a stabilizing influence during the Asian financial crisis of 1997-98) until the end of last month, so that swings in the net balance of its current account and private capital flows have been instead mirrored in its levels of foreign exchange reserves.

In order to maintain the exchange rate fixed at Rmb8.28 to the US dollar, the People's Bank of China has had to sell over Rmb 3 trillion of its own currency since the end of 2002, lifting its foreign exchange reserves from US$286bn to US$711bn as of June this year. Since most of these reserves are held in US$, the PBoC (in company with Bank of Japan and other Asian central banks) has been financing a large share of the US Budget deficit. This has in turn helped to keep US government bond yields and other long-term interest rates down, in circumstances where the more than trebling of the US cash rate since June last year might have been expected to result in higher long-term interest rates.
In effect, the People's Bank of China, in company with other East Asian central banks, have been running what could be described as the greatest vendor financing scheme the world has ever known: lending to American consumers, via the US budget, the money that American consumers need to keep borrowing so that they can keep buying the products that East Asian economies need to keep selling to them so that they, in turn, can keep growing at the rates to which they have become accustomed.

China's move at the end of last month from a rigid peg to the US dollar to a 'managed' peg to a basket of currencies is an important change along the road to a more flexible exchange rate regime, but it does not amount to a retreat from China's strong preference for exchange rate stability. Although China may allow further movements in the renminbi against the basket, and although movements in the US$ against other currencies in the basket should, in principle, be reflected in movements in the renminbi against the US$, it is unlikely that China will entertain any significant appreciation of the renminbi in trade-weighted terms over the next few years.

The exchange rate regime which China has adopted is actually very similar to the one which Australia used between 1976 and the floating of our own exchange rate, with the difference that the composition of the basket is undisclosed (as is also the case in Singapore, which has a similar exchange rate regime). Rightly or wrongly, the Australian Government of the time did not consider Australia's financial system strong enough to cope with a freely floating exchange rate, at a time when our per capita GDP was (in inflation-adjusted terms) more than three times higher than China's is today.

Moreover the Australian government of the time, and senior economic advisors who in other respects were fervent advocates of a greater role for market forces in the Australian economy, (rightly or wrongly) saw control of the exchange rate as a useful instrument of economic policy, just as China's do today. It would thus ill-behove any Australian politician (or anyone else from this country) to criticize China's choice of exchange rate regime: and (in marked contrast to their American counterparts) none has done so.

Indeed, were China to move immediately – or even over an interval of a few years – to a freely floating exchange rate with free cross-border capital flows, it is just as likely that the renminbi would fall as rise, as Chinese savers sought to withdraw their savings from domestic banks of (currently) dubious solvency, in favour of overseas investments. More than anything else, this reality explains why the Chinese authorities regard reform and recapitalisation of the banking system as more important than, and a pre-requisite for, the adoption of a more flexible exchange rate system.

In some respects, the PBoC is in a similar position to that of the Bank of Japan in the aftermath of the Louvre Accord of February 1987, with the difference that the Bank of Japan's efforts to prevent the US$ falling below ¥120 were in accordance with US pressure to do so, rather than despite US pressure to do the opposite. The 1980s Japanese asset price bubble came to an end when a newly installed Governor of the BoJ, Yasushi Mieno, took the view that the bubble was undermining the egalitarian basis of Japanese society and kept raising interest rates until the bubble burst.

It is plausible that a similar view could at some point be adopted by the PBoC if property prices in Chinese cities were to continue rising at a rapid pace, further widening perceived inequalities between the coast and the interior. However such a decision seems unlikely to be contemplated ahead of the 2008 Beijing Olympics.

Any decision by the PBoC to discontinue its policy of doing 'whatever it takes' to prevent a rise in the Rmb against the US$ (a decision which would likely be mirrored by other Asian central banks) would undoubtedly have significant consequences for the financing of the US budget and current account deficits, and hence for US long-term interest rates and asset prices. In that sense, it is difficult to understand why US legislators and officials are so anxious to have the PBoC embark on precisely such a course.

All of which illustrates the point that the world has rarely responded rationally to the rise of a new economic power. Indeed if one wants to be really pessimistic on this score one need only refer to Robert Kagan's observation that "rarely have rising powers risen without sparking a major war that reshaped the international system to reflect new realities of power … There is no reason to believe that we are any smarter today than the policymakers who mismanaged the rise of Germany and Japan"[13].

There are, however, plenty of reasons to *hope* that we are smarter than those policy makers – the benefits to Australia being not least among them.

[13] Robert Kagan, "The Illusion of 'Managing' China", *The Washington Post*, 15 April 2005.