

## Australia-China Tensions and the Impact on the A\$

- The bilateral relationship between Australia and China is set to remain somewhat challenging, posing a risk to Australia's economic outlook.
- This report discusses two medium-term scenarios for the bilateral relationship and their corresponding impact on the Australian dollar.

Diplomatic tensions between China and Australia remain elevated, posing a continued risk to the Australian economic outlook given the country's reliance on Chinese demand for its exports. The bilateral relationship has been strained for some years already, yet it tensed up significantly in April 2020 following Australia's call for an international inquiry into the origins of the COVID-19 outbreak. Since then, China has imposed various restrictions and/or tariffs on imports of Australian barley, wine, red meat, coal, lobster, cotton, and timber, and it has warned Chinese citizens against travelling to Australia. Meanwhile, Australia's authorities have advised that Australians may be at risk of arbitrary detention in China. In addition, the Australian government's decision to suspend its extradition treaty with Hong Kong after China imposed the National Security Law on the territory has challenged the relationship further. Please refer to the Appendix for a more detailed timeline of the conflict.

We note that Australia's economic dependence on China is much larger than China's reliance on Australia. China is Australia's most important export market; it purchases 42% of Australia's total global shipments and half of its commodity exports (See chart 1 for Australia's exports to China). Moreover, the Australian services sector has found significant support from Chinese demand in recent years; as of 2018, over 15% of Australia's total tourist arrivals come from China—one of the highest shares among advanced economies globally—while China is also a notable source of international students in Australia. China's economic dependence on Australia is mainly limited to commodities; in 2019, Australia was the supplier for 60% of China's iron ore imports (chart 2) and 43% of coal imports (chart 3).

Given the uneven importance of the bilateral economic ties, this report looks at two scenarios for the Sino-Australian economic relationship and how each would impact the trajectory of the Australian dollar. We first discuss a scenario in which the relationship between Australia and China stabilizes on the back of a modest de-escalation in the US-China tensions. The second will discuss the potential for a further deterioration in the bilateral relationship, putting Australia's iron ore shipments to China at risk.

### SCENARIO 1: STABILIZATION IN RELATIONS

Protectionist biases globally are expected to ease slightly over the next couple of years, reflecting the new US administration's policy agenda. We expect President Joe Biden to increase the US's multilateral engagement with the rest of the world and to restore more traditional forms of diplomacy in its engagement with China. While we note that there seems to be bipartisan support in the US Congress for being tough on China, we do not expect the US-China relationship to worsen under the Biden Administration. As such, any de-escalation—or even just a

### CONTACTS

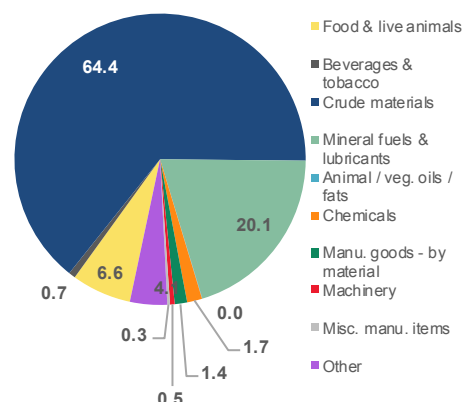
**Tuuli McCully, Head of Asia-Pacific Economics**  
65.6305.8313 (Singapore)  
Scotiabank Economics  
[tuuli.mccully@scotiabank.com](mailto:tuuli.mccully@scotiabank.com)

**Shaun Osborne, Chief FX Strategist**  
416.945.4538  
Foreign Exchange Strategy  
[shaun.osborne@scotiabank.com](mailto:shaun.osborne@scotiabank.com)

**Juan Manuel Herrera, FX Strategist**  
416.866.6781  
Foreign Exchange Strategy  
[juanmanuel.herrera@scotiabank.com](mailto:juanmanuel.herrera@scotiabank.com)

Chart 1

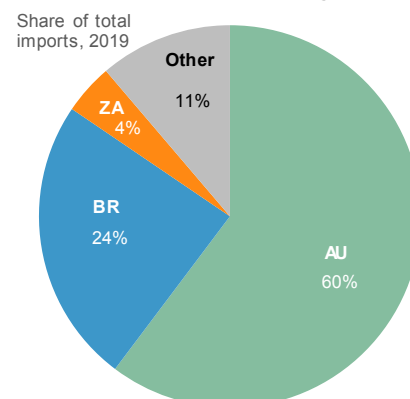
Australian Exports to China  
% of Total (2019)



Sources: Scotiabank Economics, Australian DFAT.

Chart 2

China's Iron Ore Imports by Source



Sources: Scotiabank Economics, UN Comtrade.

stabilization—in the US-China conflict would allow the US's allies, such as Australia, to continue deepening their engagement with China in areas of mutual benefit.

In the context of a less-inflammatory policy environment globally, we believe that Australia and China would be able to avoid a further escalation in their bilateral conflict. In fact, we assess that there is some potential for improved diplomatic dialogue between the two countries following the expected ratification of the Regional Comprehensive Economic Partnership (the world's largest free trade agreement in which both Australia and China are signatories) in 2021. Moreover, once the COVID-19 pandemic fades, a more stable relationship would likely allow for a resumption of international travel between the two countries.

Under this scenario—combined with our base case forecast (table 1) of maintained growth-supportive monetary and fiscal policies globally (including in Australia and China) through 2022—we expect China's economic growth to remain strong, keeping the country's commodity demand solid. Such a backdrop would underpin global commodity prices, benefiting Australia's export sector. Prices of iron ore—Australia's main export—are expected to stay elevated this year, averaging at 115 USD/t in 2021, before easing somewhat to 85 USD/t next year as supply in Brazil picks up and speculative activity lessens. Accordingly, Australia's terms of trade (chart 4) are anticipated to remain favourable through 2022.

### The AUD Under Scenario 1

We assume steady bilateral relations between Canberra and Beijing in our base case outlook for the AUD. We expect the AUDUSD to reach \$0.80 later this year (table 1, again), in keeping with a generally weaker USD tone, firm commodity prices as the global economy and global trade recover, and strengthening domestic growth which will reduce pressure on the Reserve Bank of Australia (RBA) to ease monetary policy further in the coming months—and increase the odds of a conclusion to its A\$200 bn bond buying programme by the end of 2021.

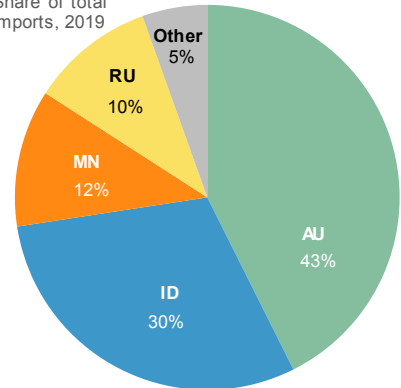
The AUD staged one of the strongest rebounds among the major currencies from the COVID-19-inspired market volatility and is currently trading more than 25% above the level prevailing at the end of March last year. It did, however, also experience one of the sharpest declines of the major currencies as the pandemic spread in early 2020, falling some 17% from the start of January through to March. We have noted in other publications that AUD extreme weakness to the 0.60 cent point or below has always been associated with significant market turbulence and heightened volatility (around the dot com crash, Great Financial Crisis, and last March's volatility, for example). The AUD typically recovers in a strong and sustained manner from these episodes of extreme weakness and this supports the case for steady gains in the AUD in the months ahead. Equity market volatility as implied by the CBOE's volatility index is still about twice as high on average as in 2019 and recently reached a three-month high. A decline from these levels should lift the AUD.

From a longer run point of view, the currency has only recovered a little more than a third of the sell-off that took place against the USD from the \$1.10 peak seen in 2011 to last year's trough at \$0.55 and remains below both its 10-year and 20-year moving averages which are clustering around the \$0.80 point. The Aussie traced the near 80% drop in iron ore prices between 2011 and 2015 but has, all things considered, failed to capitalize on the rebound in iron ore to roughly 10% below its decade-ago

Chart 3

### China's Coal Imports by Source

Share of total imports, 2019



Sources: Scotiabank Economics, UN Comtrade.

Chart 4

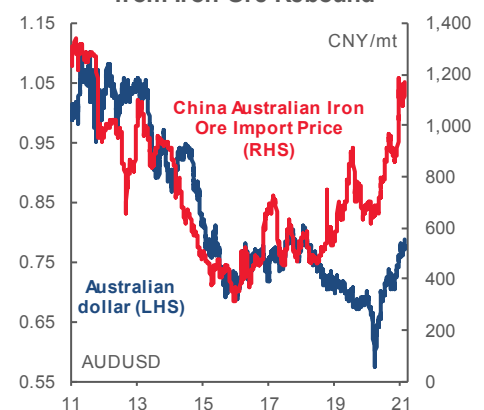
### Australia's Terms of Trade



Sources: Scotiabank Economics, Australian Bureau of Statistics.

Chart 5

### AUD Sees Limited Gains from Iron Ore Rebound



Source: Bloomberg, Scotiabank FICC Strategy.

highs (chart 5), with the narrowing of the AUD's yield advantage over the USD to blame for the currency's underperformance (chart 6).

While the slide in iron ore prices stopped in 2015, Australia's 5-yr spread over the US continued its drop since late-2010 to near minus 1% in 2019. The 5-yr spread returned to around par last year as the Fed cut rates by 150 bps compared to the RBA's 65 bps reduction but has still about 400 bps (or 80%) to make up in ground lost since its peak in late-2010. The RBA's Kent noted recently that were it not for the bank's policy actions (rate cuts, yield curve targeting, and bond purchases), the AUD would be about 5% higher from current levels—around \$0.82. We think that the bank will close out its A\$200 bn bond-purchase programme by year-end, while maintaining its yield-curve control policy, and keep rates unchanged through our forecast horizon. Combined with a tapering of the Fed's bond purchases by early-2022, the AUD is unlikely to gather much support from rate differentials but an improved growth outlook (at home and abroad) with robust commodity prices and easing virus risks will act as modest tailwind.

Considering that speculative positioning currently is relatively flat, it is not hard to envisage some potential for the AUD to overshoot our forecast and reach the \$0.83 levels on the back of strong export prices and lukewarm (or no further deterioration in) relations with China, which would equate to the 50% retracement of its long-term decline from \$1.10.

## SCENARIO 2: FURTHER ESCALATION OF THE CONFLICT

The opposite trajectory for the Sino-Australian relationship would be a further deterioration, potentially triggered by miscalculated political judgements by either party. We assess that from the Australian viewpoint, the biggest risk related to the conflict is that China's retaliatory actions spread to iron ore. As over 80% of Australia's iron ore shipments are destined to China, a significant drop in exports—similar to that in coal (chart 7)—would be a substantial blow to the economy. In June 2020, China implemented some changes to customs inspection rules for iron ore. While the new rules are meant to streamline customs processes, we note that they could potentially be used for retaliation, i.e. to slow customs clearance for Australian iron ore. Nevertheless, given China's dependence on Australian iron ore to feed its steel industry, we assess that an imminent escalation covering iron ore is unlikely.

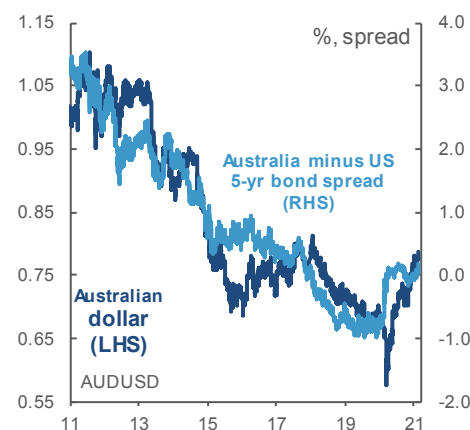
A worsened conflict would naturally hurt Australia's external sector. Moreover, it would have a negative impact on consumer and business confidence, slowing Australia's nascent economic recovery following the pandemic-triggered recession. Accordingly, the labour market, consumer spending and business investment could take longer to rebound, requiring Australian monetary and fiscal policymakers to maintain accommodative policies in place longer than we currently expect. Indeed, should confidence be hit hard, the government and the RBA would likely step in to provide further stimulus to the economy. We assess that additional monetary easing would most likely be in the form of expanded quantitative easing, yet we point out that the potential for a benchmark interest rate cut from the current level of 0.10% into negative territory could not be fully dismissed.

## The AUD Under Scenario 2

In the event of a further deterioration in bilateral relations, we expect that markets would move quickly to price in slower domestic growth and the risk of further

Chart 6

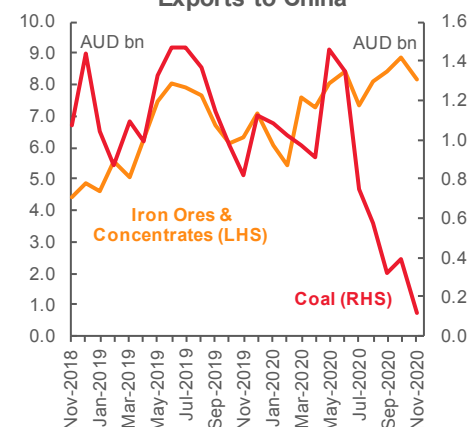
### AUD Loses Yield Advantage vs USD



Source: Bloomberg, Scotiabank FICC Strategy.

Chart 7

### Australian Coal and Iron Ore Exports to China



Sources: Scotiabank Economics, Australia DFAT.

Table 1

Scotiabank Australia Key Forecasts			
	2020F	2021F	2022F
<b>GDP, annual % chg</b>			
Australia	-3.1	2.8	2.6
<b>CPI, % EoP</b>			
Australia	0.9	1.6	2.1
<b>Policy Rate, EoP</b>			
RBA Cash Rate Target	0.1	0.1	0.1
<b>Exchange Rate, EoP</b>			
AUDUSD	0.77	0.80	0.78
<b>Commodity Prices</b>			
Iron Ore (USD/t)	110	115	85
Coal (USD/t)	125	125	140
LNG (USD/MMBtu)	2.13	2.8	2.58

Sources: Scotiabank Economics, Bloomberg.

monetary stimulus from the RBA into the AUD. While it remains an option, we do not think the RBA will be clearly motivated to test the negative-rate waters, particularly as Chinese trade measures are an external factor; a rate cut may only have a marginal economic impact and could risk increased froth in domestic housing markets.

An escalation of the China-Australia conflict could significantly delay a rate liftoff—to possibly lag the Federal Reserve's first—and keep the RBA's quantitative easing and yield-curve control programmes in place (or expanded). Until a resolution is found at the executive level, Australia's economic potential will remain subdued. With low rates for longer on the horizon and other central banks moving closer toward normalization, the spread of Australian debt yields over the US and Canada could again turn significantly negative and lead to an underperformance of the Aussie.

While Australian commodity producers may face barriers in trade with China, global demand for raw materials would not necessarily diminish as the post-pandemic recovery becomes more widespread; commodity prices might not fall significantly and Australian producers could—eventually—find alternative markets for products (at lower prices, however, while unable to recoup losses in 'slower' trade with China), tempering downside pressure on the AUD. Nevertheless, an escalation in Chinese tensions with Australia could motivate the G7 (or most of the G20) to show a united front against Chinese geopolitical pressure that would result in heightened uncertainty in financial markets and slow global growth (as in 2018-19) amid Sino-Western discord. In this scenario, commodity prices would face an additional obstacle that would drag on the AUD and other commodity currencies.

The combination of lower rate differentials, subdued domestic confidence, geopolitical tensions, and weaker commodity prices could pull the AUD exchange rate to as low as the key \$0.70 mark in our estimation—compared to our latest forecast of \$0.80 by end-2021. China's push to become the leading global economy means, however, that the Xi government will have to eventually abstain from long-lasting measures that impact its imports of raw materials. We think that the AUD would eventually recover somewhat thanks to an improvement in bilateral relations—at least with diminished impact on goods trade—but sentiment in the currency will remain cautious unless Australia significantly diversifies its export destinations (a tall task).

## CONCLUSIONS

We expect the Sino-Australian relationship to remain challenging over the coming quarters—and years—despite the fact that both countries benefit from the bilateral economic ties. In the foreseeable future, Australia will likely deepen its efforts to diversify its export markets and reduce its trade dependence on Chinese demand, yet we assess that any progress is set to remain limited. Given China's expected real GDP growth outperformance over the coming years, the country will continue to increase its economic might globally. By our calculations, China is on track to become the world's largest economy within the next decade or so. Accordingly, Australia will continue to be exposed to fluctuations in Chinese demand for years to come.

We highlight that there is significant uncertainty regarding the outlook for the bilateral relationship. Out of the two scenarios laid out in this report we assess that the first scenario is slightly more likely. Nonetheless, any material improvement in the relationship is unlikely to happen within the next few quarters as handling the adverse economic consequences of the COVID-19 pandemic takes priority and as the political/policy environment remains strained globally. Realistically, we assess that a stabilization of the relationship would represent the most optimal outcome in the current context. We consider that the second and more pessimistic scenario is unlikely to materialize in the near future given the importance of iron ore to China, particularly now that the Chinese economy is recovering from the COVID-19 slump with the help of stimulus-driven fixed investment. While iron ore may be safe from retaliatory actions, we note that some other Australian exports—particularly agricultural goods such as wheat, dairy, and fruit—could be at risk instead. Nonetheless, the economic significance of such exports is small enough that the Australian economy as a whole would be able to avoid significant harm.

Our baseline Australian dollar scenario incorporates some degree of lingering anxiety over future China-Australia relations but global forces in commodity prices and an improving risk mood should lift the AUD toward the \$0.80 mark by end-2021. The AUD may see some additional gains as the RBA possibly concludes its A\$200 bn bond purchase programme later this year, but Governor Lowe and other central bank officers will likely 'talk' the currency down. In the negative scenario, the AUD is at risk of touching the \$0.70 level as heightened trade tensions force the RBA to maintain ultra-accommodative policy for longer while other central banks (namely the Fed) proceed with policy tightening, further eroding the AUD's yield appeal. A combined Western response to China's trade actions would also lead to a period of elevated market anxiety and depressed growth that weaken commodity- and risk-sensitive currencies like the AUD.

**APPENDIX—TIMELINE OF AUSTRALIA-CHINA TENSIONS**

Jian Kun Ng, [jiankun.ng@scotiabank.com](mailto:jiankun.ng@scotiabank.com)

Date	Party	Action
June 2018	Australia	Australia's Parliament passes a package of new laws designed to prevent foreign influence in the country.
August 2018	Australia	The Turnbull government blacklists both Huawei and ZTE from Australia's 5G network in response to security advice. Together with the US, Australia lobbies other Five Eyes nations to exclude Huawei from the construction of new telecommunications networks, claiming Huawei could provide covert access to Chinese intelligence.
February 2019	China	Port of Dalian bans Australian Coal import and caps overall coal import from all sources for the year of 2019 to 12 million tonnes. At the same time, major ports across China prolong clearing times for Australian coal to at least 40 days.
February 2020	Australia	Australia begins anti-dumping investigation into Chinese aluminium micro-extrusions. Australia decides to continue anti-dumping duties on Chinese deep drawn stainless-steel sinks after review.
March 2020	Australia	Australia begins anti-dumping investigation into cheap precision pipe and tube steel from China, South Korea, Taiwan and Vietnam.
April 2020	Australia	Australian government begins canvassing support for an international inquiry into the origins of COVID-19. Australia did not consult China about plans for the inquiry before pursuing it internationally. Australia begins another anti-dumping investigation into A4 copy paper exported by China, Brazil, Indonesia and Thailand.
May 2020	China	China suspends meat imports from 4 Australian abattoirs. The 4 plants make up about 35% of Australian beef exports to China. In 2019, Australia exported A\$2.8 billion worth of beef to China. China imposes anti-dumping and anti-subsidy duties totalling 80.5% on Australian Barley. In 2019, Australia exported AUD 550 million worth of Barley to China.
	Australia	Australia continues to impose anti-dumping duties on Chinese Silicon Metal after review. Australia initiates anti-dumping into painted steel-strapping from China and Vietnam.
June 2020	China	China issues travel warning for Australia, citing discrimination and violent behaviour against Asians and Chinese due to COVID-19.
	Australia	Australia expands anti-dumping investigation to include aluminium zinc coated steel from China and Vietnam.
July 2020	Australia	Australia suspends extradition treaty with Hong Kong in response to fears over the National Security Law enacted by China in Hong Kong. Australia assesses possible continuation of duties on Chinese steel reinforcing bars and Chinese hot-rolled rod in coils of steel. Australia initiates anti-dumping investigation into copper tubes from China and South Korea. Australia updates travel advice for China, warning that Australians might be at risk of arbitrary detention on National Security grounds.
August 2020	China	China launches anti-dumping and anti-subsidy probes on some Australian wine. China is the largest export market for Australian wine. China suspends imports from a fifth meat processing plant in Australia.
	Australia	Australian treasurer Josh Frydenberg goes against the advice of the Foreign Investment Review Board and the Australian Competition and Consumer Commission to block China's Mengniu Dairy Company's buyout of Lion Dairy & Drinks from Japan's Kirin Holdings. He said that the sale was "contrary to national interest". The deal was worth USD 434 million. Australia plans to tighten rules on states' and universities' foreign deals by requiring any deals with foreign countries to get final approval from the foreign affairs minister. Confucius Institutes as well as Victoria State's Belt and Road deal with China could potentially be cancelled.
September 2020	China	China suspends barley imports from Australia's largest grain exporter CBH grain and orders stricter inspections of Australian wheat and barley. Australia exports more than half its barley to China and is the biggest barley supplier to China.
October 2020	China	China's custom authorities tell several Chinese state-owned steelmakers and power plants to stop importing Australian coal. Chinese cotton mills are ordered to stop buying Australian cotton. Millers who insist on buying Australian cotton might not get a quota to import in 2021 or could be hit with a 40% tariff. China is the biggest buyer of Australian cotton.
November 2020	China	China imposes temporary anti-dumping measure on Australian wine imports. The duties range from 107.1% to 212.1%. For the year ending September 2020, China made up 39% of Australia's total wine export value. China finds Australian coal imports failed to meet environmental standards, leaving more than USD 500 million worth of Australian coal anchored off Chinese ports. China cuts imports of Australian copper concentrate by more than half. China rejects Australia's appeal to scrap anti-dumping and anti-subsidy duties on barley. China bans barley shipments from Australia-based grain exporter Emerald Grain. China bans Australian timber from Victoria and Queensland. Chinese Foreign Ministry spokesman Zhao Lijian's tweet provokes condemnation from Australia PM Scott Morrison. He calls the image "repugnant" and dismisses it as "false" and "misinformation". He also demands an apology from Beijing. In response, Co-Foreign Ministry spokesperson Hua Chunying defends the tweet, stating that Australian PM's assertions are wrong. She says that the image was a graphic created by a young Chinese artist based on the inquiry report issued by the Australian Defence Department.
	Australia	Australia's Woodside Petroleum shelves talks to sell stakes in a gas field and liquefied natural gas (LNG) project to Chinese firms because of the diplomatic row. Lion Dairy is sold to Australian firm Bega Cheese in a deal worth USD 412 million.
December 2020	China	China formally blocks Australian coal imports. China ramps up imports from Mongolia, Indonesia and Russia, and expands local production. China imposes temporary anti-subsidy measures of 6.3-6.4% on Australian wine imports. China suspends beef imports from sixth Australian beef supplier.
	Australia	Australia lodges formal complaint to WTO over barley anti-dumping duties.



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