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Edited by Kevin Chinnery: kchinnery@fairfaxmedia.com.au

Get used to a new tense relationship with Beijing

THE AFR VIEW

Last Tuesday, in a piece published on *The Australian Financial Review's* opinion pages, former Australian ambassador to China Geoff Raby upbraided Julie Bishop for Canberra's frosty relationship with Beijing and called for her removal as Foreign Minister. The story developed into a vociferous debate about Australia's relationship with China, with a rather terse and defensive government justifying its record.

The story struck a nerve because the nerve has been exposed. Australia is now grappling with a difficult new phase in our China relationship. After the wide-eyed bonanza of our resources boom, the downsides and friction of that relationship are now showing up. Until the past year or so, Australian foreign policy was predicated on avoiding choices between our defence guarantor, the United States, and our biggest export market. Now it has shifted to a new phase: working out where China's rise should be accommodated and on which points Australia should push back.

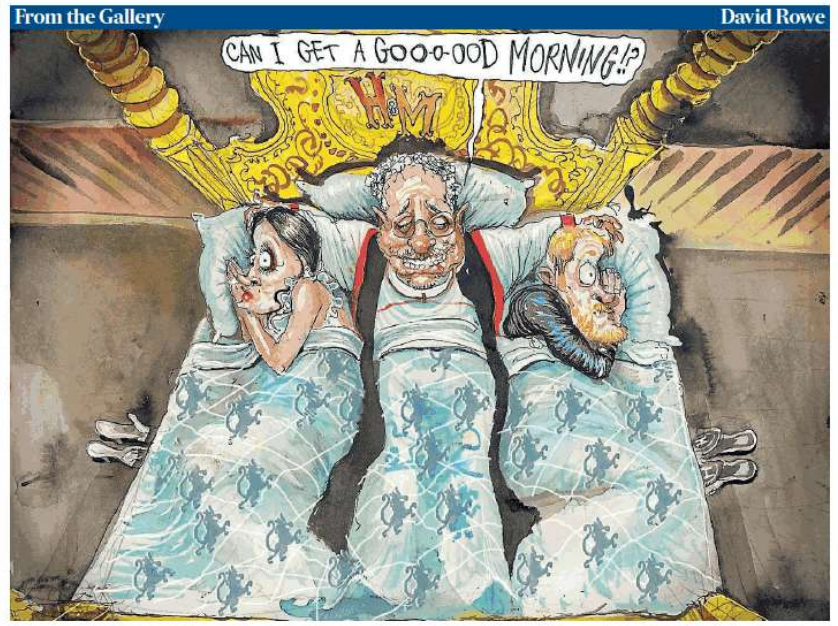
This task has been complicated by the gadfly presidency of Donald Trump, who is disrupting the international rules-based order Washington created after World War II. While China is disrupting the security order, Mr Trump is challenging free and open global trade rules, threatening to start a trade war with Beijing by seeking to somehow cut America's trade deficit with China by \$US200 billion.

After a rocky start, the Turnbull government has handled the volatile Mr Trump as well as could be expected. But relations with Beijing have soured after the government fuelled anti-Chinese paranoia as part of the political attack on then Labor senator Sam Dastyari for apparently warning a Chinese national he was being spied on by Australia. The Dastyari affair brought into the open the broader influence of China and the Communist Party in Australian politics, through the universities and in civil society. This came against the backdrop of a rapid Chinese expansion in the South China Sea that flouted international law, as well as the "debtbook" diplomacy of lavishing cash loans onto poor Asian and Pacific nations that could leave them exposed to Beijing's diplomatic leverage. Some suggest that Australia must bow down to the reality of Chinese power dominance. But the Indo-Pacific region is more contestable than this school of thought suggests. Australia retains a huge national interest in the peaceful rise of a more prosperous China. But, as China seeks to exert influence proportional to its rising economic and strategic clout, our bilateral relationship may become more strained. China's authoritarian one-party government may "punish" us from time to time for sticking to our values and pursuing our strategic interests. That's not a cause for panic.

It should also be remembered that China itself faces big challenges, including a debt build-up, a demographic crunch caused by the one-child policy and the inherent contradictions of an authoritarian state that needs to give more power to citizen consumers to drive its next phase of growth. Australia must avoid adding unnecessary friction to the relationship and welcome China's economic progress, but also stand true to our own sovereign values and interests. That will require Australia to deepen ties with like-minded partners and, critically, ensure that we support our sovereign interests by not wasting our own economic potential through petty political squabbles.

A resilient institution

It really was a fairytale wedding: the sixth in line for the throne and brother of the future king marrying a divorced actress from a broken home and a lower-middle class African-American background. Underneath the pomp and pageantry, at the heart of the royal wedding was a family institution – the Windsors – that has shown a remarkable resilience and an ability to remake itself over the past 100 years of wars, depression, loss of empire, personal scandal and modernism. The now Duke and Duchess of Sussex, ironically, also seemed to democratise the royal family: any girl can now become a English princess. In a hyper-social media world of declining trust in institutions, that's an achievement to ponder.



Qultaly is now a real possibility

Eurocepticism
Italy survived the GFC with the EU intact, but will the EU survive Italy's new populist government?



Gabriele Gratton and Richard Holden

Italy is about to embark upon a full-scale experiment in Euroceptic populism. A Five Star-Northern League (Lega Nord) coalition government has been announced by Luigi Di Maio, the head of the Five Star Movement, and Matteo Salvini, who leads the League.

Populism may not be new in Europe – in the years since the global financial crisis Greece nearly left the European Union, and Britain is in the process of actually doing so. Both of those episodes were scary enough for the countries involved, and the world economy more broadly.

But Italy's new government may usher in the biggest crisis of all. In many ways the fate of the European experiment depends on its outcome.

Italy – a founding member of the European Community in 1957, cornerstone of the EU – is under withering political and economic pressure to abandon the common currency and leave the EU. You know things are serious when there's a cute name for the prospect of a country leaving the EU (think Grexit and Brexit). In this case that prospect has been dubbed "Qultaly" by University of Chicago professor Luigi Zingales.

A little background – first, the economy. Italy was hammered by the global financial crisis. While in the US real gross domestic product fell by 4.2 per cent from the end of 2007 to the middle of 2009, in Italy, GDP fell by an annualised rate of as much as 7.2 per cent during the crisis, only returning to consistent positive territory in 2014. US GDP returned to pre-crisis levels by late 2011; in Italy real GDP is still below its 2007 level. At around 1.5 per

cent, Italy's annual GDP growth is the lowest in the whole euro area.

US unemployment shot up from 4.7 per cent to 10 per cent, but steadily declined back to 4.7 per cent by 2016 and is now close to 4 per cent. Italy's unemployment rate roughly doubled to above 12 per cent. It is still at 10.9 per cent. Youth unemployment peaked at 42.7 per cent in 2014 and remains around 35 per cent.

The EU response to the crisis was too little, too late. Italian voters asked for fiscal relief. The EU replied with austerity policies.

Then comes immigration. Italy's geographical position made it the natural European entry point during the recent refugee crisis. The EU failed to reach a long-lasting agreement on how to distribute the costs of the crisis, leaving Italians with a disproportionate share of the burden.

It's no surprise, then, that at the March 4 Italian elections a majority of the Italian voters favoured Euroceptic parties.

Almost one-fifth voted for the Northern League party of Matteo Salvini, a man who, referring to the recent refugee crisis, said that Italy needs "a mass cleaning – home by home, street by street, neighbourhood by neighbourhood".

Even more shockingly, fully one-third of Italians voted for the Five Star Movement, a party founded by stand-up comedian Beppe Grillo, and whose animating call to action was the establishment of so-called "Vaffa Days" (translated to "f–you" or "f–off" days). That tells you what message Grillo and his supporters are trying to send to the Italian and EU political establishment.

Italy's gigantic public debt does not allow any room for internal fiscal relief. To boost demand, then, there remain two choices: fiscal spending underwritten by the EU itself or monetary policy. Both instruments are in the hands of EU institutions, dominated by Angela Merkel's German government.

But while Italy needs highly accommodative monetary policy, the European Central Bank seems to be moving to normalise it. ECB chief economist Peter Praet recently said: "Our monetary policy measures are bearing fruit, and the growth outlook confirms our confidence", and Dutch central bank governor Klaas Knot who sits on the ECB's governing council opined: "The top priority is to normalise monetary policy



and strengthen the economic and monetary union." A larger EU budget, favoured by French President Emmanuel Macron, seems elusive. And there has been little progress by the EU on the refugee crisis.

Without a strong EU answer, the new Italian government may need to deliver on its promise to slash past pensions reforms, cut taxes, and introduce universal basic income.

With markets weary of a possible Italian default and EU institutions blocking increases in public deficits, none of this may be possible without a referendum to leave the euro.

If Italy does leave the euro, however, it triggers an automatic exit from the European Union itself. That may well end the whole European project.

Unlike Greece, Italy is a huge economy. And while Britain is big, it was never part of the euro zone. Its political support for the European project was always tepid. Even when it entered in 1973 it did so reluctantly, and public support was never much above 60 per cent in subsequent decades. Italy, by contrast, had the founding treaty of Europe named after its capital, and enjoyed public support for European integration above 80 per cent. Not so any more.

Macron spoke last month of the risk of a "European civil war". Thankfully, that may never happen. But for the European project to survive, the EU must answer the questions posed by Italian voters soon. The EU would not survive Qultaly.

Gabriele Gratton is senior lecturer and Richard Holden professor, both of economics at UNSW Business School.

