



Dealing with the Dragon: Australia and Chinese Inward Investment

Mark Thirlwell

1 April 2010

Beginning in late 2007, Australian policy-makers and politicians were faced with a wave of Chinese inward investment, most of it directed towards the resource sector. Managing that investment surge presented Canberra with a tricky policy problem. The key lesson of Australia's experience to date for other countries facing an increase in Chinese investment is the need not only to reach a clear decision on how to respond to Chinese money, but then to communicate that decision in a timely and effective manner. This means deciding in which, if any, cases the particular nature of Chinese or other state-controlled investment flows raise concerns that do not apply to private capital flows, and then indicating how the investment framework will be used to tackle these cases.

Chinese Investment under the Rudd Government

Until quite recently, there had been a stark gap between the strength of Australia's bilateral trade relationship with China and the relatively under-developed nature of the investment relationship. Trade linkages between China and Australia are substantial and still growing. Last year, China finally overtook Japan and became Australia's largest merchandise export market. In 2009 China was responsible for more than one-fifth of Australia's merchandise export earnings. Australia is now China's largest supplier of bulk commodities. Similarly, in 2009 China was Australia's largest source of merchandise imports, selling Australia almost 18 per cent of the total, and it is an increasingly important market for Australian services. China is Australia's largest source of overseas students, and the fifth largest source of tourists to Australia.

In contrast, until recently the bilateral investment relationship was much more modest. As recently as December 2008, the stock of total Chinese investment in Australia was negligible. At about A\$ 8 billion (US\$ 7.3 billion, or 5.4 billion euro, at today's exchange rate), it was less than half of 1 per cent of total foreign investment, and China was only ranked the fifteenth largest foreign investor. Australian investment in China is similarly modest.

This big gap between trade and investment never looked like a sustainable equilibrium. Given China's strategic concerns about resource security, and under most sensible forecasts for the two economies, China's investment stake in Australia was always going to grow significantly. The key questions were: (1) how fast would this happen; and (2) how smooth would the process be? So far, the answers are: (1) surprisingly quickly; and (2) a bit bumpy, actually.

The start of the current surge in Chinese investment in Australia coincided roughly with the election of the Rudd government in November 2007. In the following two years, Canberra approved some 111 Chinese investment proposals, together worth more than A\$ 39 billion. That compares with just A\$ 14.5 billion of Chinese investment approved over the previous decade. The destination for the bulk of that investment has been the resources sector, although some has also found its way into property.

Policy Response and the Regulatory Framework

The policy response to this increase in investment sought to balance several competing factors:

1. A need to maintain good relations with Australia's most important economic partner. China's rapid economic growth and its consequent demand for resources has been a substantial contributor to Australian prosperity. Australian voters and businesses are well aware of this fact, and Australian governments want to be seen to be managing the relationship effectively.
2. Australia has historically been a net importer of capital: the country has run current account deficits in nearly every year since federation. This means that the overall foreign investment regime must be such that it reassures foreign investors in general. Investment protectionism is certainly not an option.
3. The fact that most Chinese investment is channelled through companies that are under the control of the Chinese government means that Chinese investment looks qualitatively different than previous foreign investors in Australia. This has been a source of some public disquiet, since there have been concerns that Chinese investment will be motivated by, and perhaps subsequently act upon, issues that go beyond the narrowly commercial.
4. While a reasonable working assumption regarding the behaviour of private-sector investors is that they are interested in maximizing profits given the constraints imposed by their shareholders, the same is not necessarily true of state-owned enterprises, where government objectives might come into play. In particular, in the case of investment in the Australian resource sector, there is a potential conflict of interest when a state-controlled investor is involved, since there could be different national interests over pricing strategies (that is, Australia as a producer would want to maximize resource rents, while China as a consumer could prefer lower prices).
5. Canberra is in the middle of long-running negotiations with China over a possible free trade agreement (FTA). There has been some concern that 'concessions' on Chinese investment would spend negotiating coin better conserved for the FTA process.
6. Finally, there is a need to pay at least some attention to Australia's domestic politics, which have encompassed a range of potentially sensitive factors including a (quite mild) case of resource nationalism, demands for reciprocity in terms of investment access, and variable public attitudes towards China more generally.

In practice, balancing these factors mainly involved making judgements regarding which cases of investment produced potential problems along the lines of points (3) and (4) above, and using the foreign investment framework to mitigate these concerns. The good news for the Australian government was that Australia's regulatory framework gave it ample (indeed, some critics charged, far too much) flexibility to deal with the challenge posed by Chinese money. Foreign investment in Australia is regulated by the Foreign Acquisitions and Takeovers Act (FATA) of 1975 and by the government's Foreign Investment Policy. While advice is provided by the Foreign Investment Review Board (FIRB), the Australian Treasurer has ultimate responsibility for foreign investment decisions. The regime is intended to ensure that foreign investment is not 'contrary to the national interest', and since the national interest is not anywhere formally defined, this provides a significant degree of freedom of action, subject mainly to the constraint of maintaining Australia's overall attractiveness as a destination for foreign investment.

Spillover to the Bilateral Relationship

The not-so-good news was that although the regulatory regime itself was not a problem for Canberra when it came to managing Chinese investment, the application of that regime—and

even more importantly, the communication to Chinese investors about how that regime would be applied—did become an important problem.

Given the complex trade-offs involved, it was probably inevitable that policy decisions on Chinese investment would end up being controversial. This was particularly going to be the case with something as high-profile as the now-infamous Chinalco–Rio Tinto deal: if it had come off, this would have been China's largest ever overseas investment and Australia's biggest corporate deal. (Ultimately, that deal was rejected by Rio's shareholders in a commercial decision. But this came after the Australian government had delayed making a ruling, which in effect allowed time for market conditions to shift, and hence the attractiveness of Chinalco's proposition to decline.) Nevertheless, the Australian authorities initially failed to do a good job in explaining either to the Chinese or to anyone else how they would treat the incoming investment. Instead, there was a gradual process whereby—through a combination of press releases, speeches and public announcements—Canberra gradually made its position clear: it has sought to combine a general welcome to Chinese money with a specific concern about cases where there is a potential conflict of interest along the lines described above or where other issues deemed to be in the national interest are in question (for example, maintaining a listing on the Australian Stock Exchange).

While this process was unfolding, a great deal of criticism was levied at the authorities regarding the lack of transparency in the investment approval process, their failure to deliver timely decisions on key investments, and about the delivery of muddled messages to Beijing regarding whether Chinese investment was actually welcome or not. Some of this inevitably spilled over into the bilateral relationship, which suffered as a consequence.

The Need for a Clear Message

It is certainly not the case, however, that all of the blame for the relationship's problems that arose during 2009 in particular was to be found on the Australian side. It is also true that during 2009 the bilateral relationship had to deal with several complicating factors, including the impact of Australia's Defence White Paper (which assigned an uncomfortably prominent role to China), Canberra's decision to grant a visa to Rebiya Kadeer, leader of the World Uyghur Conference, and the arrest in China of Australian national and Rio Tinto employee Stern Hu. Nevertheless, the problems over investment did involve some collateral damage to the relationship, and some of that collateral damage could perhaps have been avoided if Canberra's final policy position had been communicated as soon as it was formulated.

There was also some concern expressed by the financial community and other observers that Australia's lack of clarity on these issues was confusing—and perhaps even off-putting—to other potential foreign investors.

In conclusion, Australia's existing foreign investment regime—the FATA and the FIRB—provided the authorities with all of the tools that they needed to regulate Chinese investment. No additional restrictions or policies were required. Indeed, in most cases, there was no threat to Australia's national interest, and hence no need for their provisions. The main challenge arose in the small number of cases where there was a potential conflict of interest arising because of China's interests as a resource consumer and Australia's interests as a resource provider. The national interest test provided adequately for these occasions. Rather, the main difficulty involved communicating the intent of Australia's policy response. Sending China a clear message right from the start about how Australia would respond could have improved the effectiveness of the whole process, although this would have required Canberra to have confirmed its position quite early in the proceedings.

Mark Thirlwell is Director of the International Economy programme at the Lowy Institute for International Policy, Sydney, Australia.

© 2010 Clingendael Asia Forum

For information on how to contribute an article, please visit <http://www.clingendael.nl/asia/forum/>

To subscribe to, or unsubscribe from, the email distribution list, please contact RDrange@Clingendael.nl