



ITS Global

Consultants on Global Issues

**Foreign investment in
Australia – China and
common sense**

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Executive Summary

Foreigners built Australia

Australia has been built not just on the contribution of migrants, but on foreign investment. Every major phase of Australia's industrial and economic development has been driven by foreign capital used to supplement savings by Australians. Chinese investment in mineral development is the next chapter in this story.

Invest more in the tough times

With the current global economic downturn and the country effectively in recession, the best way out is to encourage investment and make the best use of productive resources. Turning away foreign capital in the current climate is nonsensical. In the case of Rio Tinto, the company has said that without cooperating with China's Chinalco, Rio faces having to cut nearly 2,000 jobs in Australia.¹

Australia's economic recovery and future prosperity rely on the continued welcoming of foreign investment, including from China, and continuing liberalization of foreign investment policy.

Remain an open and global player

Australia has always prospered from being open to global markets. When we sought to isolate our national producers from overseas competition, particularly in the 1970s and early 80s, we suffered. Australia's foreign investment laws were at their most restrictive during this period of economic nationalism. The *Foreign Acquisitions and Takeovers Act* was introduced in 1975.

The idea that Australia benefits from freer trade in goods and services is now entrenched. As the Mortimer Review on the competitiveness of Australia's trade noted, successful participation in the global economy now as much depends on freedom of foreign investment.

We've seen it before...

In the 1970s and 80s there was a lot of talk about Japanese investors striving for global domination. The fears were groundless. Japanese companies were subject to influence by the Japanese Government and many acted both as shareholders in production and as customers of those products. Several of those companies in the end proved commercially unviable. Yet Governments

¹ Rio Tinto CEO, Tom Albanese quoted by Yan, J., 'Test time for Chinese overseas acquisitions', *Caijing Magazine*, 25 March 2009, at <http://english.caijing.com.cn/2009-03-25/110127468.html>

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then did not seek to regulate those investments to protect against those fears. The same concerns are now being expressed about Chinese investment.

China is still a small outward investor

As it stands, China is a minnow when it comes to outward FDI. Compare its 2007 stock of outward FDI of US\$96 billion, to the US\$2.8 trillion the United States has invested overseas, the US\$8 trillion invested overseas by the European Union and even the US\$272 billion of FDI Australia has overseas.²

Similarly, China is a small investor in Australia. At the end of 2007, the total stock of FDI in Australia (all countries) was A\$377 billion.³ In 2007 there was an inflow of US\$532 million of Chinese FDI into Australia contributing to a total stock of Chinese FDI in Australia at the end of 2007 of US\$1.4 billion.⁴ At the same time, at the end of 2007, the United States stock of direct investment in Australia was A\$92.8 billion (accounting for nearly one quarter of FDI in Australia), the United Kingdom's stock of A\$64 billion and Japan's of A\$27 billion.⁵ We can expect China's FDI to have increased in 2008, but it's coming off a very low base.

Not the same old China

Concerns about China's state-owned enterprises (SOEs) are manageable. SOEs are clearly profit-driven - they need to be. China is anxious to prove itself worthy of its new status as a global economic power and has significantly reformed its SOEs over the last decade. As the Foreign Investment Review Board (FIRB) has already shown in its approval of Hulan Valin, a Chinese firm, acquiring a stake in Australian miner, Fortescue, conditions can be framed to ensure transfer pricing concerns are managed.

This is China's big test

This is *the* test for China given it has fallen at the last hurdle in several major plays in the minerals sector in North America in the last five years. There would be a substantial signaling effect of another successful Rio Tinto investment to other key developed country markets.

² United Nations Conference on Trade and Development (UNCTAD), *World Investment Report 2008*, Annex Table B.2. Note, China's Ministry of Commerce (MOFCOM) reports China's stock of outward FDI at the end of 2007 as US\$117.91 billion. MOFCOM, *2007 Statistical Bulletin of China's Outward Foreign Direct Investment*.

³ Australian Bureau of Statistics (ABS), *5352.0 – International Investment Position, Australia: Supplementary Statistics, 2007*.

⁴ MOFCOM, 2007; Foreign Investment Review Board (FIRB), *Annual Report 2006-07*, Chapter 4.

⁵ ABS, 5352.0.

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And we won't lose control of Aussie resources

Ultimate control of Australian resources remains with the Australian governments. They retain sovereign power to revoke exploration and mining licenses. Such action must be taken carefully – it could deter future foreign investment. Nevertheless, that power is never wholly surrendered.

Chinese investment is a no-brainer

We should not decide our approach to investment from China on the basis of reciprocity. It is not relevant whether Australian investors could take a stake in a Chinese mine or not. Welcoming all investment is the best approach. In any case, there is considerable and growing Australian investment in China.

It is in Australia's national interest to welcome Chinese investment and to make the best use of productive resources in tough economic times. The Government will set conditions to help give Australians assurances that Chinese investors can be depended on.

Introduction

Foreigners built Australia

Australia has been built not just on the contribution of migrants, but on foreign investment. Every major phase of Australia's industrial and economic development has been driven by foreign capital used to supplement savings by Australians. Chinese investment in mineral development is the next chapter in this story.

Invest more in the tough times

Now is the worst time to turn away from foreign capital. The best way out of the current global economic downturn is to encourage investment and make the best use of productive resources. Failure to do this prolonged the Great Depression in the United States. Fostering investment now builds the basis for future economic growth and protects jobs. Rio Tinto Ltd has said that without investment by Chinalco, Rio faces having to cut nearly 2,000 jobs in Australia.⁶

Australia's economic recovery and future prosperity rely on continuing to encourage foreign investment, in the foreseeable future, particularly from China.

Australia's prosperity depends on being a player in the global economy

Australia's high living standards are built on foreign investment

Australia is a successful country with a high standard of living. GDP per capita is above the OECD average⁷ with the economy providing higher incomes to a population that has increased from 8 million in 1950 to 13 million in 1970 and to over 21 million today.⁸ Until the onset of the global

⁶ Rio Tinto CEO, Tom Albanese quoted by Yan, J., 'Test time for Chinese overseas acquisitions', *Caijing Magazine*, 25 March 2009, <http://english.caijing.com.cn/2009-03-25/110127468.html>

⁷ Department of the Treasury (Wilkie, J. and Grant, A.), 'The importance of evidence for successful economic reform', *Economic Roundup*, Issue 1, March 2009, http://www.treasury.gov.au/documents/1496/PDF/04_Evidence_and_reform.pdf

⁸ Australian Bureau of Statistics, *3101.0 Australian Demographic Statistics* and *3105.0.65.001 Australian Historical Population Statistics*.

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recession, more Australians than ever were in work with 62 per cent of the population employed,⁹ and until recently unemployment was below 5 per cent.¹⁰

Australia has a long history of using foreign investment to access greater funds than available through domestic savings, to invest and increase growth, employment and living standards.¹¹ FDI has also increased international competitiveness by exposing local management to international business standards and best practice. It has provided access to advanced technologies and business innovations through the establishment of new businesses and the modernization of existing ones. All have helped to raise productivity and living standards. Foreign investment is estimated to have contributed \$25 billion to real national income between 1996 and 2006.¹²

It has been taken as a given since Australia's record period of prosperity beginning in the early nineties, that economic growth depends on an open and global competitive economy. Key features are low tariffs, a floating dollar, financial deregulation, reduction in capital controls, introducing fiscal and inflation targets, privatizations of government owned entities, and microeconomic reform. The result was Australia's GDP per capita increased in the 1990s faster than the OECD average for the first time in many decades.¹³

It is easy to forget that we have had the experience of falling living standards as a result of closing the economy by raising tariffs and restricting foreign investment in the late 1970s and early 80s. By the mid-1980s, effective rates of tariff assistance in manufacturing and agriculture were around 15 to 20 per cent¹⁴ and unemployment had jumped to above 10 per cent. Australia's GDP per capita had been declining compared to the average for OECD countries for several decades.¹⁵ A similarly protective stance was taken during this period towards foreign investment. Since the 1960s foreign

⁹ Australian Bureau of Statistics, *Labour Force Australia*, Catalogue No. 6202.0, Table 1 Labour force status by Sex – Trend.

¹⁰ Australian Bureau of Statistics, *Labour Force Australia*, Table 1 Labour force status by Sex – Trend. Unemployment in March 2009 was 5.7 per cent.

¹¹ Department of the Treasury, 'Foreign investment policy in Australia – a brief history and recent developments', *Economic Roundup*, Spring 1999, at <http://www.treasury.gov.au/documents/195/PDF/round5.pdf>

¹² Makin, T., 'Capital Xenophobia and the 'National Interest'', paper prepared for symposium on 'Australia's Open Investment Future', *Institute of Public Affairs*, Melbourne, 4 December 2008, p. 11.

¹³ Wilkie and Grant (2009).

¹⁴ Productivity Commission, *Trade & Assistance Review 2006-07*, Annual Report Series, Canberra, March 2008.

¹⁵ Henry, K., The Committee for Economic Development of Australia (CEDA) 40th Anniversary Annual General Meeting Dinner, 19 November 2001, at <http://www.treasury.gov.au/documents/67/HTML/tsld023.asp>

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direct investment inflows have averaged around 2 per cent of GDP. Between 1970 and the mid-1980s when foreign exchange controls and foreign investment policy were more restrictive than at any other time in Australia's history foreign direct investment inflows averaged around 1 per cent of GDP.¹⁶ Together with trade barriers above global averages for industrialized economies, the resulting misallocation of resources is estimated to have reduced capital productivity over the period by 30 per cent.¹⁷

While successive governments since the economic reforms of the early eighties have maintained an open trade policy, in recent years, restrictions on foreign investment have increased. Australia's system of screening substantive foreign investments imposes costs on investors and deters investment. Previous research by ITS Global suggests these restrictions have reduced GDP by as much as 0.5 per cent, reducing Australia's capacity to build prosperity by participation in the global economy. This is at odds with the important role investment has played in our economic development and continues to play today.

Australia as a player in the global economy

Australia has always been a player in the global economy. We have derived benefits from our natural resources (not just farms and mines, our human capacity as well) by trading those advantages in foreign markets and attracting foreign capital to finance them.

We need foreign capital. The reason is simple economics. We don't develop our resources to supply just the small Australian market. No company would finance that; the return would be too small to make it commercially viable. We develop our natural resources to supply world markets. That generates prosperity in Australia and we need global capital to fund that.

Foreign capital has been used to grow many industries. Our natural economic partners have always been the world's biggest economies – the United Kingdom, the US and Japan. Our biggest trading partners have also been our primary sources of foreign capital.

United Kingdom

From its beginnings as a British colony, Australian production has been supported by British investment. From the 1820s Australia's economic growth was built on exporting wool and other rural commodities to Britain and Europe with large amounts of capital provided by Britain for

¹⁶ Department of the Treasury (1999).

¹⁷ Evans, T., 'Economic nationalism and performance: Australia from the 1960s to the 1990s', *Ninth Annual Colin Clark Memorial Lecture*, 4 June 1999.

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pastoral and mining production in Australia.¹⁸ British companies with a long established presence in Australia include the Australian Agricultural Company from 1824 and British banks and mortgage companies operating in the Australian colonies from the 1830s. Wheat exports began in the 1870s and from the 1890s the introduction of refrigeration allowed for the export of perishables such as meat, dairy products and fruit.

In the first half of the twentieth century British multinationals including Shell, Imperial Tobacco, APOC, Pilkington's, Courtaulds, Dunlop, George Kent, Cadbury and Roundtree began to establish factories in Australia, Canada, New Zealand, South Africa and Ireland as international rivalry intensified.¹⁹ Since the 1950s, Australia's reliance on British capital declined and direct investment into Australia from other countries grew. Even so, the UK has remained the second largest investor in Australia with a stock of FDI at the end of 2007 of A\$64 billion.²⁰

United States

The United States is the largest source of FDI in Australia accounting for a stock of A\$92.8 billion, almost a quarter of all inward FDI.²¹ Through the twentieth century investment from the United States has contributed to the development of Australian manufacturing and mining. For example, in the 1940s General Motors won a government tender and began production of Holden motor cars in Australia. US manufacturing and oil companies such as General Electric, IBM and Exxon have all had a long presence in Australia.²²

In the 1950s and 60s, US companies began investing in the minerals sector.²³ By the mid 1960s, America investment in the Australian mining industry was second only to that in the manufacturing sector and was of rapidly growing significance.²⁴ Large investments by American companies included

¹⁸ Attard, B. 'The Economic History of Australia from 1788: An Introduction', *EH.Net Encyclopedia*, edited by Robert Whaples, March 16, 2008, at <http://eh.net/encyclopedia/article/attard.australgia>

¹⁹ Tolentino, P., *Multinational Corporations: Emergence and Evolution*, Routledge, 2001.

²⁰ Australian Bureau of Statistics (ABS), *5352.0 – International Investment Position, Australia: Supplementary Statistics, 2007*; Foreign Investment Review Board (FIRB), *Annual Report 2006-07*, Chapter 4.

²¹ ABS, 5352.0; FIRB 2006-07.

²² APEC Study Centre, *An Australia-United States Free Trade Agreement - Issues and Implications*, 2001, at http://www.dfat.gov.au/publications/aus_us_fta_mon/

²³ Tolentino (2001)

²⁴ Brash, D. *American investment in Australian industry*, Harvard University Press, 1966
<http://books.google.com.au/books?id=As9QfYJXzicC&printsec=frontcover&dq=american+investment+in+australia+n+industry&lr=#PPA10,M1>

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Asarco's (then American Smelting and Refining Company) majority ownership of Mount Isa Mines, and Cleveland Cliffs Iron Company and Kaiser Steel Corporation as just two of a number of American companies developing iron ore deposits in Western Australia. Brash estimated that up to 1962, overseas investors had met 57 per cent of the cost of Australia's oil exploration program with American sources major contributors to that total.

In the 1990s, US firms were major players in the buy-up of privatized government assets, accounting for 28 per cent of the value of total assets sold. For example, US businesses invested heavily in the energy sector acquiring stakes in electricity and gas distribution businesses and bought and constructed power stations in Victoria, Western Australia and Queensland.²⁵

Japan

From the mid-1960s, Japanese capital has also played a key role in developing certain sectors in Australia, notably the resource and energy industries.²⁶ Japan is currently the third largest source of foreign direct investment in Australia, behind the United States and the United Kingdom.²⁷

An important characteristic of Australia's economic relationship with Japan over the past half century has been Japan's reliance on Australian raw materials and the role Japanese investors in Australia have played in upstream production and as consumers of raw material output.

As Malcolm Maiden, Business commentator in "The Age" noted "Japanese groups were in on the ground floor for the development of some of Australia's biggest and best resources export projects, acting as both shareholders and customers."²⁸ Considerable foreign investments were made to develop these resources "when local banks and capital markets were either unable or unwilling to chance their own arms."²⁹

Mitsui, Mitsubishi, Nippon Steel, Sumitomo, and Japanese electricity utilities have had a prominent role in the development of Australia's resources industry. Beginning in 1963, Japanese Mitsui, Australian Thiess Brothers and US Peabody joined to develop the Moura coal mine in central Queensland. Other investments followed in the 1970s and 80s in iron ore and coal and related transport infrastructure. Mitsui, Nippon Steel, Sumitomo and Japan Australia LNG (MIMI) contributed capital towards the

²⁵ APEC Study Centre (2001).

²⁶ DFAT, 'Australia and Japan - How distance and complementarity shape a remarkable commercial relationship', December 2008, at http://www.dfat.gov.au/publications/aus_japan/chapter2.html

²⁷ DFAT (2008).

²⁸ Malcom Maiden, 'Chinalco deal could open more investment doors', 3 February 2009, *Businessday.com.au*.

²⁹ Maiden (2009).

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development of the Robe River iron ore deposits in north-west Western Australia and the North West Shelf gas fields. In each case the Japanese entered into joint ventures with Australian producers and the resources developed were supplied to Japan (and other customers) under long-term contracts.

Japanese investors now have 50 per cent stakes in a number of ventures. In 2001 Mitsubishi took an equal share with BHP Billiton of seven coal mines in the Bowen Basin in central Queensland and the Hay Point Coal Export Terminal. In 2002 Mitsui purchased a 49 per cent interest in coal mines owned by Anglo American. In 2003 Sumitomo and Itochu Corporation announced the acquisition of the coal interests owned by Xstrata in Queensland.³⁰

Upstream investment by Japanese companies has also been central to growth in Australia's agrifood sector. In the mid-1950s Japan began investing in export-producing sectors such as grains, oilseeds, meat and dairy ingredients. In the 1970s, Japanese firms invested in agricultural production and food processing, for example beer company, Kirin (barley malt production) and Nippon Meat Packers (cattle raising, feedlotting and processing). Japan, a major importer of Australian premium beef, is an investor in Australia's grain-fed beef industry.³¹ At the end of 2007, Japan's stock of direct investment in Australia amounted to A\$27 billion.³²

...and now China

Chinese investment should come as no surprise. Our future success and prosperity rely on continuing to access global capital markets and generating economic activity in Australia aided by foreign capital.

The pattern is unmistakable and is no accident. Throughout our economic history, Australia's main trading partners and major sources of FDI have been the world's largest economies - the United Kingdom, the United States and Japan.

China is now the world's second largest economy in purchasing power parity terms and Australia's largest trading partner.³³ Two-way trade with China totaled A\$67.7 billion in 2008. China accounted for 14.6 per cent of Australian merchandise export trade, worth A\$32.5 billion, and resource (minerals, fuels and metals) exports accounted for 86 per cent of merchandise exports to China.³⁴ However foreign

³⁰ Mimuroto, Y., Kimura, T., Koizumi, K., 'Restructuring of the Coal Industry in Australia', *The Institute of Energy Economics, Japan*, February 2004, at <http://eneken.ieej.or.jp/en/data/pdf/235.pdf>.

³¹ DFAT (2008).

³² ABS, 5352.0; FIRB 2006-07.

³³ China is the fourth largest economy in exchange rate terms. Australian Department of Foreign Affairs and Trade (DFAT), *Overview of Australia-China Relations*, April 2009, at http://www.dfat.gov.au/GEO/china/cb_index.html

³⁴ DFAT (2009).

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direct investment flows between China and Australia remain comparatively small: the stock of Chinese FDI in Australia was A\$1.4 billion at the end of 2007. Looking at the total investment position (FDI and portfolio investment), China had A\$6.2 billion invested making China the 17th largest investor in Australia. Australian total investment in China at the same time was \$5.2 billion making China Australia's 14th largest investment destination.³⁵

Increased FDI flows reflect the next phase of development of the bilateral economic partnership. This pattern follows that of Australia's very successful economic relationship with Japan from the 1970s where a fruitful trade relationship was the precursor to substantial Japanese investment.³⁶

The “threat” of foreign investment in Australia – revisiting the Japanese experience

Never a threat

The increasing number of Chinese companies seeking a stake in Australian companies is generating fears reminiscent of those when Japanese companies in the 1980s seemingly look set to buy everything in their path. As *The Economist* has noted, people “seem to have forgotten that that threat proved transient, indeed was never really a threat at all.”³⁷

Evidence supporting a similar conclusion for Chinese investment is mounting. China is a long way from global domination. China's stock of FDI outflow was US\$4.5 billion in 1990, almost US\$28 billion in 2000 and in 2007 was almost US\$96 billion.³⁸ China's FDI outflows are escalating quickly and in 2007 totaled US\$22.47 billion, up slightly from US\$21.16 billion in 2006, and almost double 2005 FDI outflows of US\$12.26 billion.³⁹

³⁵ MOFCOM, *2007 Statistical Bulletin of China's Outward Foreign Direct Investment*.

³⁶ Shearer, A. and Thirlwell, M., 'Is the Foreign Investment Review Board acting fairly?' *Lowy Institute for International Policy*, December 2008, p.15, at http://www.ipa.org.au/library/publication/1229471411_document_thirlwell_updated.pdf

³⁷ *The Economist*, 'The dragon tucks in', June 30, 2005.

³⁸ UNCTAD, *World Investment Report 2008*, Annex Table B.2.

³⁹ UNCTAD, *World Investment Report 2008*, Annex Table B.1. Note that MOFCOM statistics differ slightly: US\$26.5 billion in 2007, US\$17.6 billion in 2006, and US\$12.3 billion in 2005. MOFCOM (2007).

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Nevertheless, China remains a relatively small outward investor. Simply put, China's US\$96 billion in outward investment is dwarfed by that of the US (US\$2.8 trillion), the EU (US\$8 trillion) and even Japan (US\$542 billion) and Australia (US\$278 billion).⁴⁰

Still, to demonstrate that any threats are being addressed, investment in Australia by government-owned enterprises has been accorded a special status which requires closer review. It is standing policy that all investment by SOEs had to be approved by the Foreign Investment Review Board. The Rudd Government has mandated a specific set of tests that are to be met by SOE investors from China. Previous analysis by ITS Global concluded that the effect of requirements is likely to politicize investment from China.

The risks most commonly cited about investment by Chinese SOEs which warrant these concerns are that:

- if the investor is a consumer or has enterprises which are a consumer of the goods produced by the entity in which the investment is to be made, it will acquire market knowledge of prices which will put the producer entity at commercial disadvantage;
- the investor may not be commercially viable; and that
- government ownership may result in the enterprise being directed to serve political rather than economic ends.

All of these factors were features of Japanese investment in Australia in the eighties, but none at the time were regarded as reasons to restrict or to subject investment by Japan to special conditions.

Japanese companies investing in Australia have been both producers and customers

Japanese trading companies have been both shareholders of Australian producers and customers in the minerals and metals sectors. The numerous instances of this are set out on pages 8-9. There was clear evidence that Japanese trading companies performed multiple roles as both buyers and sellers of Australian resources. Kazutoshi notes that historically Japanese "general trading companies would first import coking coal, sell it to a Japanese steel company, transfer the steel products to a shipbuilding company, negotiate with ship owners for the sale of the ships, promise the ship owner the use of his ships when importing iron ore in future, sell the iron ore thus imported to the steel company and so forth".⁴¹ And Beeson has concluded that "the trading houses' principal profits in the coal industry are

⁴⁰ The United States is the largest outward investing country with an FDI stock of US\$2,791,269 million in 2007. At the same time, the EU's stock of outward FDI was US\$8,086,111 million, Japan's was US\$542,614 million, and Australia's US\$277,917 million. UNCTAD 2008, Annex Table B.2.

⁴¹ Kazutoshi, M, 'Business Activities of General Trading Companies', in *General Trading Companies: A Comparative and Historical Study*, 1990, at http://d-arch.ide.go.jp/je_archive/english/society/book_jes3_d04.html.

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derived from commissions on coal sales, often from both buyers and sellers. Ensuring control of the high volume trade is of greater significance than securing a profit from a small stake in an Australian mine".⁴²

Australia's foreign investment policy and government statements regarding the policy have been silent on this issue in the past. Any concerns about the possibility of transfer pricing⁴³ reducing the benefits for Australia from the involvement of Japanese trading companies were apparently insufficient to warrant a change or tightening of regulatory control or even warrant a mention in public statements on foreign investment policy by successive Australian governments.

Given the Japanese experience, in retrospect regarded as wholly favorable to the Australian economy, of investors buying and investing in resources in Australia and selling them on to other parts of the company in Japan, there does not seem to be any reason why there should be concern about such a possibility with Chinese investment.

Even when they were bankrupted we benefited

The commercial viability of foreign investors has historically not been of concern to Australian regulators. We have not been concerned about whether investors might make bad business decisions or go bankrupt. This has certainly been the case with Japanese investors. We are fully familiar with giant Japanese conglomerates managing the Australian trade in wheat, beef and coal exports. We would never know about the internal financial affairs of these companies. We don't require them to verify their fiscal health. Even if we tried, we would learn little. Japanese investments in Australia have gone bad in the past, but when they did, Australia still benefited.

If a Chinese state-owned enterprise doesn't operate like a proper company the situation is no different to a wholly privately owned company, foreign or not, taking bad business decisions.

Australia showed no concern about the financial health of Japanese companies making substantial investments in Australian rural and urban land and in housing in the 1980s.⁴⁴ Property investment was driven by Japan's own land price bubble. Japanese companies used the rising value of land they owned

⁴² Beeson, M, *Bilateral Economic Relations in a Global Political Economy: Australia and Japan*, 1997, at http://espace.library.uq.edu.au/eserv/UQ:10524/mb_cc_pre97.pdf.

⁴³ That is, the pricing of assets, services and funds transferred within an organisation, in particular where multinational entities may set transfer prices on cross-border transactions.

⁴⁴ There was a significant increase in Japanese investment in Australian real estate during the 1980s. For example, by 1988 Japan controlled 18 major hotels and resorts, a Brisbane koala sanctuary, coach lines and four large shopping complexes. More acquisitions were planned and made thereafter. Welfield, J, 'Australia's relations with Japan and the Korean Peninsula, 1981-1990' in Boyce, P. and Angel, J. (eds.), *Diplomacy in the Marketplace, Australia in World Affairs, 1981-1990*, 1992, p. 267.

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as a means of borrowing to finance foreign investments. By late 1991, the total value of land in Japan was estimated at nearly \$US20 trillion – more than 20 per cent of the world's wealth. Real estate assets of Japanese corporations grew by \$US2.8 trillion from 1986 to 1988 – an increase in valuation roughly equal to the size of Japan's the gross national product.⁴⁵ Not surprisingly, there was “a strong correlation between net capital outflow and property-related bank lending” in Japan during that time.⁴⁶ However, by 2000 the Japanese urban land price index had fallen back to its 1985 level, after peaking in the early 1990s.⁴⁷

Much of the Japanese investment in real estate (and other sectors) in Australia during the 1980s is likely to have been financed by increased land prices in Japan. Investment in real estate was therefore likely to have been “off balance sheet”. So even if Australian authorities were concerned about the viability of those making the investments, they would have been unable to determine long term financial viability by examining the published accounts of an investing company.

Australia was not concerned with this phenomenon. An examination of public statements by Australian government ministers in the 1970s and 80s announcing changes in Australia's foreign investment arrangements bears this out. For example, in October 1985, the Minister assisting the Treasurer, Mr. Hurford, announced the liberalization of provisions for the development and sale of real estate to Australians.⁴⁸ And in July 1986 Treasurer Keating removed the 50 per cent Australian equity guideline for acquisitions of real estate of \$10 million or more⁴⁹ announcing that “the changes will make it easier for foreign investors – both in partnership with Australian firms and on their own account – to pursue opportunities in manufacturing and service industries which have been enhanced by the recent sharp improvement in Australia's competitiveness.”⁵⁰ If Australia had been concerned about Japanese

⁴⁵ Dehesh, A. and Pugh, C., 'Real Estate Cycles, Internationalised Transmission Mechanisms and the Japanese 'Bubble' Economy 1985-1995', *The Royal Institution of Chartered Surveyors*, 1996, at http://www.rics.org/NR/rdonlyres/4EBF43D2-F140-4E67-ACE7-EA75F5A515C8/0/real_estate_cycles_19960101.pdf.

⁴⁶ Dehesh and Pugh (1996).

⁴⁷ United States Joint Economic Committee, *Policy Lessons from Japan's Lost Decade*, December 2008, at <http://www.house.gov/jec/Research%20Reports/2008/rr110-30.pdf>.

⁴⁸ Snape, R., Gropp, L. and Luttrell, T., *Australian Trade Policy 1965-1997, A Documentary History*, Allen & Unwin, 1998, p. 724.

⁴⁹ Snape, et. al. (1998), p. 725.

⁵⁰ Snape, et. al. (1998), p. 725.

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companies investing in rural and urban land, these and other policy changes that relaxed investment arrangements would presumably have included measures designed to address these concerns.⁵¹

Government influence on Japanese investors

It is well known that in Japan, Government can exercise considerable informal influence over business. The links between Government and business are well documented.⁵² The Japanese government took an active interest in where and how Japanese companies invested in Australia and elsewhere. They were seemingly more concerned about changing Australian public perceptions of Japanese investment than the Australian Government was with the inflow of Japanese capital. The Japanese Ministry of Finance began exercising 'administrative guidance' over the flow of investment into Australian real estate. "At the January 1989 Australia-Japan Ministerial Committee meeting in Tokyo the Japanese Foreign Minister Uno Sosuke announced his intention to exercise very careful scrutiny of investment in Australia."⁵³ Throughout this period the Australian Government maintained its line and attitude towards Japanese investment and continued to progressively liberalize foreign investment policy - albeit from a highly regulated starting point. These were not the actions of a Government concerned about foreign government 'administrative guidance' of foreign investment.

Australia's approach to Japanese investment in the past suggests similar aspects of Chinese investment can be managed in the same way.

The foregoing demonstrates that when Japanese investments started to increase in Australia there is no indication that there was official concern by Australia that Japanese companies had financial stakes in both producers and consumers of Australian resources, or that the investors may not have been commercially viable, or that there may have been foreign government influence exercised over the operations of those investors.

⁵¹ In his statement on foreign investment guidelines on 1 April 1976, former Treasurer Lynch noted that "We are particularly concerned that foreign interests should not engage in speculative purchases of real estate. Therefore, except for certain specified types of real estate investment, all acquisitions of Australian real estate by foreign interests will be examinable". Snape, et. al. (1998), p. 717. While there was concern about speculation in real estate, there was no apparent concern about the financial viability of those making the investments. That is understandable. If those making an investment in Australia go bankrupt, it will have to be sold to someone else: real estate cannot be moved offshore. In an extensive analysis of Japanese investment in Australia by Pokarier, there is no suggestion that Australian authorities were concerned about the financial viability of Japanese investors or how they were financed. Pokarier, C., 'An interest in Japan: The political economy of Australia-Japan investment linkages', Asia-Pacific Economic and Business History Conference, Gakushuin University, Tokyo, 18-20 February, 2009, at <http://www.uow.edu.au/commerce/econ/ehsanz/Tokyo%20Conference%202009/Papers/Pokarier.pdf>

⁵² See for example work of Chalmers Johnson.

⁵³ Welfield (1992).

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The Chinese economy has been transformed by the reforms initiated by Deng Xiaoping in the early 1980s and continued by his successors. Living standards for hundreds of millions of Chinese have improved dramatically, especially in coastal areas. But around 800 million people remain in rural poverty. The Government no longer seeks to create a centrally planned communist state. Its objective is to improve the living standards of the Chinese people through economic growth. The Chinese leadership has made continuing that process a high priority. The bottom line is that state-owned enterprises need to generate wealth.

That so many major companies in China are SOEs reflects China's institutional development as it evolves from a centrally planned to a market economy. In light of this the real issue is not the legal ownership of the investing entity but the objectives of its owner in making the investment. If those objectives are essentially commercial in nature, and are expected to remain so, there would seem little point in worrying about the formal ownership independence of the SOE.

Two related developments show how China has changed and go towards establishing the veracity of its commercial intentions: first, reform of the SOE sector undertaken since the 1990s and, second, China's entry into the global trading system through its membership of the World Trade Organization (WTO).

Reforming SOEs

From the 1990s, China embarked on reform of the state-owned sector. In 1993 the Fourteenth Party Congress approved a policy to transform state-owned enterprises into modern enterprises whose ownership could be diversified. The objective was to create competitive markets for state and non-state enterprises to operate within and to reform China's social security system by "freeing up the prices, initiating necessary labour reforms, setting up and reforming the social security system, building the necessary political consensus by reaffirming these reform priorities as well as by bringing in the required constitutional amendments".⁵⁴ Listing larger SOEs was done to separate management and operations from the government and to increase efficiency.⁵⁵

⁵⁴ Gupta, P. and Palit, A., 'Reform of the state owned enterprises in the People's Republic of China', *Asian Development Bank*, draft paper for discussion, accessed 27 March 2009, p. 11, at <http://www.adb.org/Documents/Events/2008/PRC-India-Emerging-Lessons/Paper-Poonam-Gupta.pdf>

⁵⁵ Gupta and Palit, p. 28.

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In 1998 China had 5.6 million SOEs. They accounted for 80 per cent of all enterprises, employed 122 million people, and produced 57 per cent of non-farm gross domestic product (GDP).⁵⁶ By 2006 the role of the State in the economy had shrunk so dramatically that there were only 1.8 million SOEs employing fewer than 76 million workers to produce only 35 per cent of non-farm GDP.⁵⁷

China's extensive SOE reforms to date have been an unqualified success. China has deliberately avoided the 'shock therapy' of rapid privatization, which had occurred in the former Soviet Union. Although the Chinese Government kept key sectors under State ownership, it formalized and clarified SOE objectives, streamlined the legislative regimes to regulate business and the agencies that administered them, broke up sectoral monopolies into multiple competing businesses, gave SOE management and staff strong incentives to improve financial performance, including through employee ownership, and allowed foreign investors to buy into its SOEs.⁵⁸

The performance of Chinese SOEs has significantly improved but they are still not as efficient as their private sector counterparts. The efficiency gap between them is substantial and there is no evidence it has narrowed.⁵⁹ Profitability of many SOEs is low. The median SOE was earning a rate of return of only 1.5 per cent on its assets in 2003. A third of SOEs lose money.⁶⁰ Almost two thirds of SOEs failed to earn a return of 5 per cent.⁶¹ Yet the top SOEs are performing well. Fourteen Chinese SOEs now rank among the top 500 enterprises in the world, compared with only five in 1998.⁶² As we in Australia know from the case of Australia Post, Government enterprises can be profitable and successful.

⁵⁶ Wildau, G., 'Albatross turns phoenix', *China Economic Quarterly*, 12:2, Beijing: Dragonomics Advisory Services Ltd., June 2008, pp. 27-33.

⁵⁷ Wildau (2008).

⁵⁸ Wildau (2008).

⁵⁹ The OECD in its 2005 study of China found SOEs to have a consistently lower return on capital compared to firms in the private sector. For state owned enterprises this increased from 0.4% in 1998 to 6.7% in 2003, compared to 2% to 10.2% for China's private firms. OECD, *OECD Economic Surveys: China*, (Paris: Organisation for Economic Cooperation and Development, 2005).

⁶⁰ *New Economist*, 'Do China's Firms Make Healthy Profits', October 19, 2006, at http://neweconomist.blogs.com/new_economist/2006/10/profits_and_pro.html.

⁶¹ Zheng, J. and Bigsted, A., *Can China's Growth be Sustained? A Productivity Perspective*, at <http://cei.ier.hit-u.ac.jp/activities/seminars/papers/conference-2.pdf>

⁶² Consulate General of Switzerland in Shanghai Commercial Section, at http://www.sinoptic.ch/shanghaiflash/texts/pdf/200502_Shanghai.Flash.pdf.

An important driver of reform in the SOE sector is the requirement that government-owned entities provide pensions for current and former employees. China has an ageing population so must ensure SOEs are sufficiently profitable to meet pension payments.⁶³ The State is effectively the biggest superannuation company in China. Like all superannuation funds, it needs a return on its investment to lift living standards in China. This acts as a strong incentive for major SOEs to act as good corporate citizens and operate on a commercial basis. It would be perverse for the Chinese government, having implemented SOE reforms to improve the profitability of its firms, to then compromise the profitability of major overseas resource sector investments by looking to keep world prices lower.

The Financial Times concludes that “China is trying to create a series of leading public companies in industries exposed to cut-throat competition, where technology, design and marketing are critical features – just the sort in which state-owned companies have typically suffered at the hands of private rivals”.⁶⁴ This underscores the transformation process underway in China and instills confidence in the objectives of Chinese investors.

WTO membership

China's WTO membership, acquired in December 2001, is a second indicator that we no longer deal with the same old China. WTO membership carries with it a commitment under international law to retain a capitalist model economy and participate in the rules-based global trading system. China has committed under the WTO to continue to reform SOEs: “to partially eliminate state subsidies and *eventually to let all SOEs operate on a commercial basis, making them responsible for their own profits and losses*” (italics added).⁶⁵ According to the Chinese Government, China sought WTO accession to promote further reform and open up its economy.⁶⁶

Keyuan has concluded that “(s) ince entry into the WTO, China has quickened its pace of revising its existing laws and regulations” and that “the idea of the rule of law has been gradually accepted by the

⁶³ Between 1990 and 2030 the proportion of the population over 60 will have increased from 9 per cent to 22 per cent. Yusuf, S., Nabeshina, K. and Perkins, D., *Under New Ownership: Privatizing China's State Owned Enterprises*, Stanford University Press, 2006, p. 19.

⁶⁴ Dyer, G. and McGregor, R., ‘China's Champions: Why State Ownership Is No Longer Proving A Dead Hand’, *Financial Times*, 16 March 2008, at http://search.ft.com/ftArticle?queryText=mgregor+chinalco&y=0&aie=true&x=0&id=080214000126&ct=0&page=2&ncklick_check=1

⁶⁵ Bajona, C. and Chu, T., ‘China's WTO Accession and its effects on state-owned enterprises’, *East West Centre Working Paper*, Economic Series, No. 70, April 2004, p. 15.

⁶⁶ Bajona and Chu (2004), p. 22.

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Chinese".⁶⁷ He also notes that when there are differences between domestic law and WTO regulations, the latter prevail. Halverson observes that it "is increasingly apparent that WTO accession has also provided a catalyst for China's evolution away from a legal system driven by power relationships and towards a rule-based legal system".⁶⁸

Conclusion

The risk for Australia of investment by an SOE is that it may fail or under perform commercially. This is a risk of all investment, foreign or domestic. The only difference with an SOE is that foreign government interference may be the cause of the poor performance. The key point here is that once the investment is made the risk is carried by the investor. Australia gets the money.

China has changed. It has entered international commitments which prevent it from returning to a communist economic model. It has had decades of experience with SOEs losing money and being a drain on the country. It knows SOEs need to generate wealth and they are more and more being driven and reformed to operate in accordance with normal commercial considerations. This is key to reducing poverty and improving living standards. China therefore wants its SOEs to invest responsibly and profitably.

It is not the same old China and investing in the Australian resources sector is a big test.

Australian investment – the "global test" for China

If China secures the stake it wants in Rio Tinto (currently a US\$19.5 billion bid that will increase its share of the Rio Tinto group from 9 to 18 per cent), this will be the biggest ever Chinese investment in a foreign company. Everybody will be watching. This is "the test" of China's claim its companies can operate in global markets like other businesses in major market economies.

China's SOEs have been seeking overseas acquisition opportunities since the Chinese government made internationalization a national policy in 2000. Growth overseas is seen as a prerequisite for success amongst Chinese companies and the Chinese government is undoubtedly looking to create a number of internationally competitive major TNCs that are global leaders.⁶⁹

⁶⁷ Zou, K., 'Revamping Laws for the Market Economy in the Post-WTO China', July 2006, at http://www.asienkunde.de/content/zeitschrift_asien/archiv/pdf/A100_088_093.pdf.

⁶⁸ Halverson, K., 'China's WTO Accession: Economic, Legal and Political Implications', Boston College International and Comparative Law Review, 27:2, 2004, at http://www.bc.edu/schools/law/lawreviews/meta-elements/journals/bcicl/27_2/06_TXT.htm

⁶⁹ *The Economist*, supra note 37.

Other attempts by Chinese companies to undertake big investments in foreign companies in developed markets have failed. A successful Chinalco bid for Rio Tinto goes a long way to aiding China's internationalization and to turning the tide on past acquisition failures. However these efforts fall short of representing a coordinated onslaught by China to acquire global assets. Chinese agencies are too disparate in their objectives and China lacks a single powerful coordinating agency.⁷⁰

There have been previous attempts

In 2004, Minmetals, China's largest metals and minerals trading company, acquired through open tender a 100 per cent stake in the Canadian miner Noranda for \$4.2 billion. But the transaction met opposition in Canada and from parts of the Chinese government. Indeed, China's macroeconomic management agency, the National Development and Reform Commission raised concerns about Minmetals capacity to run the merged company.⁷¹ This underscores the lack of agency coordination in China. The deal collapsed. The proposed acquisition would have been China's largest overseas acquisition.

This marked the real start of China's ambitions to acquire overseas mining assets as mineral prices shot up and the advantage of involvement in upstream activities became clear. In 2005, China National Offshore Oil Corporation (CNOOC) made an \$18.5 billion offer to buy American oil company Unocal Corporation. The acquisition attempt met opposition in the United States Congress with opponents arguing that the offer did not represent a free market transaction. They also argued there was a lack of reciprocity in acquiring similar assets in China, and even that the deal presented a regional and economic security risk.⁷² Though US regulations do not formally block investments prior to establishment, the Committee on Foreign Investment in the United States (CFIUS) can order divestment in certain circumstances. Delays and uncertainty stymied the bid.

The increasing value of the Yuan is a major reason for the rapid increase in outward FDI as foreign assets become cheaper in Yuan terms. China has also sought to make better use of its foreign exchange reserves. On 1 July 2006, the State Administration of Foreign Exchange abolished foreign exchange quotas for outward investment by foreign firms.⁷³ These factors explain the surge in outward investment in 2005.

⁷⁰ *The Economist*, supra note 37.

⁷¹ Zhao Jianfei et. al., 2009, 'How China's resource reach spread abroad', *Caijing Magazine*, at <http://english.caijing.com.cn/2009-03-05/110113386.html>

⁷² *The Economist*, supra note 37; Wikipedia, *China National Offshore Oil Corporation* (accessed 7 April, 2009).

⁷³ AFP, *Spike in Outbound Chinese Investment Could Mean Big Change*, 10 September 2006, at <http://www.spacewar.com/reports/Spike In Outbound Chinese Investment Could Mean Big Change 999.html>

Signaling effect

This deal is also the big test for China to prove wrong those who have cast doubt on China's SOE reforms. Since the mid-1990s there has been a push to reform Chinese SOEs and separate management of companies from government administration. This ensures managers have the incentive to maximize returns on capital and compete in global markets.⁷⁴

China is keen to show its SOEs are competitive and influential players in global markets but Chinese firms do not yet have a strong presence globally. In a recent list of the 100 largest TNCs operating in infrastructure related sectors (transport, communications, energy, etc.), only one is a Chinese firm (China Ocean Shipping (Group) ranks 35th based on foreign assets).⁷⁵

Thus far China's major investment deals have been in developing markets. Currently Chinese outward FDI to the EU and US is on a par with that to Africa, Latin America and Asia. According to China's Ministry of Commerce (MOFCOM), China's outward stock of FDI in the US was US\$1.9 billion in 2007. In the EU it jumped from almost US\$2.3 billion in 2006 to US\$4.5 billion in 2007, and in Australia it rose from US\$794 million in 2006 to \$US1.4 billion in 2007. Africa's stock of Chinese outward FDI in 2006 was approaching US\$2.6 billion and jumped to US\$4.5 billion in 2007 - higher than in the US and the same as the EU – and Latin America hosted a stock of almost US\$20 billion in Chinese outward FDI (principally in the British Virgin Islands and the Cayman Islands).⁷⁶

Chinese companies have gone into Africa and Asia, but on local terms. China's major outward investments have been deals struck directly with other governments. Venezuela and Russia are notable examples. As *The Economist* has noted, "they are effectively bilateral deals between states, despite the involvement of nominally private companies."⁷⁷

Any increase of Chinalco's stake in Rio Tinto will be on terms agreed by Rio and approved by the Australian Government. Even were this not so and the deal was found to disadvantage the company, then this would reinforce wariness towards Chinese companies by financial markets, investors and regulatory agencies in leading economies. It is important to China that this not occur. The implications for China's getting this right are far reaching for its energy policy and for its SOE reform policies. China's stake in overseas iron ore production is far behind that of Japan's. "China's overseas iron ore interests amount to only 40 million tons, or less than 10 percent of import volume.

⁷⁴ Wildau (2008), p.28.

⁷⁵ UNCTAD (2008), see Annex Table A.III.4, at http://unctad.org/en/docs/wir2008_en.pdf

⁷⁶ MOFCOM (2007).

⁷⁷ *The Economist*, 'Unfavoured nation – China's troubled international deals', 1 April 2009 (from Economist.com).

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Resource-starved steel giant Japan, on the other hand, holds overseas iron ore assets equal to more than 60 percent of imports.”⁷⁸

If on the other hand it gets the Chinalco-Rio Tinto deal right, obstacles to Chinese investment in Europe and the US will reduce. A successful acquisition here will greatly help signal to Washington and Brussels that the prevailing view in 2005 throughout the CNOOC-Unocal debate is no longer warranted. China wins. And Australia wins, demonstrating itself still as the world's best practice minerals rich economy for foreign investors, continuing a one hundred and fifty year tradition.

Who controls Aussie resources?

Ultimate control is retained

Australia retains ultimate control of Australian resources. Full control is never handed over. Businesses are given rights to exploit resources on the condition they pay taxes, support the local community, protect the environment and abide by national laws. Sometimes the right to use the resources is limited in time.

Governments can take those rights back if they think it necessary, though they should be careful how they do it. They might deter future foreign investors. The Queensland Government annulled mineral rights recently. That will be remembered in the future when an investor is weighing up whether or not to invest in Queensland or another state or country, all other things being equal.

Nevertheless, it shows that Governments in Australia never surrender permanently rights to mineral resources.

It has been regularly asserted that the Chinalco investment in Rio Tinto bid would result in Australia losing 'control' of vital resource assets. As mentioned above, the Chinalco proposal would increase the share of ownership from 9 per cent to 18 per cent if all convertible bonds were exercised. Since the majority of Rio Tinto's shares are not held by Australians, the company is technically not under Australian 'control'. Under Australia's *Foreign Acquisition and Takeovers Act (1975)* anything over a 15 per cent interest in Rio Tinto (an Australian corporation under the *Act*) amounts to a 'substantial interest' and is deemed a 'controlling interest' in the corporation unless the Treasurer determines otherwise.⁷⁹ However, it should be noted that this definition is for the purposes of deciding whether action is to be taken under the *Act*, i.e. where the acquisition would not be in the 'national interest'.⁸⁰

⁷⁸ Zhao et. al., 2009.

⁷⁹ *Foreign Acquisitions and Takeovers Act 1975*(Cth), section 9.

⁸⁰ *FATA 1975*, sections 18 and 19.

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Actual control of Rio Tinto will depend on overall shareholdings, the distribution of voting rights and the company's constitution.

Furthermore, the iron-ore assets in the Pilbara in Western Australia are arguably the only Rio Tinto assets of national significance in Australia. Under the deal, Chinalco would gain a 15 per cent interest in this mine. This is less than the foreign ownership of other Australian iron ore and coal assets.⁸¹

There is also concern Chinalco would acquire and subsequently divulge sensitive commercial information to others. This is not as easy as one may think. It is also little different to the same risk that Australian companies face from other commercial investors with access to sensitive information. Any FIRB approval could be accompanied by undertakings which required of Chinalco, for example to enter "information segregation agreements" such as those Hunan Valin Iron and Steel Group was required to conclude with Fortescue Metals Group. In most cases these sorts of undertakings simply reinforce obligations under existing Australian law (e.g. the *Corporations Act 2001*) and corporate governance mechanisms (e.g. a Director's Code of Conduct).

Conclusion: Chinese investment a no-brainer

Should we reject Chinese investment because the Chinese government limits Australian investment in China? Is it important that we only deal with China on the basis of reciprocity? No. Unilateral liberalization of investment barriers is the best approach. Australia can use Chinese capital to create extra economic activity and raise national income and wealth, irrespective of whether China wants to benefit from Australian investment. We may even be able to show them the benefits of welcoming foreign investment.

Australia's national interest requires Chinese investment. Australia has depended on foreign investment to build its economy since European settlement. Nothing has changed. The Government may set conditions. They will help give Australians assurance that Chinese investors can be depended upon. What they really should do is remind Australians that investment policy should be based on common sense – the common sense of encouraging people to invest in Australia.

⁸¹ Chambers, M., 'Rio deal likely to face cutbacks', *The Australian*, Friday April 17 2009, p. 20.