SENATE INQUIRY INTO FOREIGN INVESTMENT BY STATE-OWNED ENTITIES

Submission by: Bill Edwards

No individual, no corporation, no country has ever become sustainably rich by selling off productive assets. This is no time to be allowing Australia's productive assets to fall into foreign hands, particularly not our natural resources and especially not into the hands of foreign governments.

Global Grab for Natural Resources

In recent years there has been a massive reconfiguration of the ownership and control of the world's natural resources, especially in the areas of energy resources, bulk minerals and industrial metals. In the oil and gas sector, for example, in the 1970s oil majors (large, independent, free enterprise, multinational companies) controlled around 70% of the world's oil and gas reserves. Today they control around 10% as against the estimated 80% now controlled by sovereign wealth funds and national (government-owned) oil companies. These government-owned bodies not only want control of their own countries' assets but they are actively and rapidly seeking to control assets throughout the entire world for the benefit of their own nations. The Indian government, which has decided to sustain and expand the Indian state's virtual monopoly in the oil and natural gas sector, is looking to buy assets all over the globe. Proshanto Banerjee, chairman of Gas Authority of India Ltd, has said "We need to catch up with China because in whichever country we go they have a presence – in exploration, in refining and in gas." Meanwhile independently-owned oil and gas companies are struggling to access resources often carefully guarded by government-owned bodies.

In the area of coal, the Indian government is sending a delegation to Australia in the near future to look at buying some of our coal assets. An Australian trade official, apparently enraptured by their economically amorous intentions, has been crowing about how wonderful it is that they are interested in buying our precious assets. How short-sighted! How naive! As an aside, the same delegation is looking at purchasing assets in our car components industry.

In other areas the same sort of thing is happening. In mineral sands the Saudi government-controlled Cristal has taken over listed Australian company Bemax, which holds some of the world's best mineral sands deposits in the Murray Basin. Cristal is a processor of mineral sands, so we have a foreign, government-controlled customer getting total control of an Australian supplier. This all happened just as Bemax was starting to hit its stride as a producer. Australian shareholders were denied the long-term benefits. In return they received what will prove to be a low price for their shares.

In <u>iron ore</u> China has been trying to buy control of the Midwest iron ore province in Western Australia and is now seeking a large slice of Rio Tinto including about half of the iconic Hammersley project. In recent court hearings Fortescue Metal's Andrew Forrest said that Chinese government-controlled Valin, which now owns a substantial stake in the iron ore producer, had no sooner stuck a deal to buy iron ore from the company, than (a week later) it was pressuring him to take control of the entire company. Last year I wrote to my local Federal (ALP) member advising him, among other things, that allowing China to buy our assets would be like feeding the crocodile. Its hunger would never cease and it would end up eating the zoo keeper. The Fortescue experience is but one small example of this.

In <u>bauxite</u> China has already been given control of major resources.

In the <u>base metals</u> area Chinese government-controlled Minmetals is attempting to take over OZ Minerals. Some commentators have said that doesn't matter because OZ Minerals is not of great strategic significance. OZ Minerals is the world's second largest zinc producer and that doesn't matter??? Speaking of zinc, the Chinese have also taken control of Perilya, another zinc producer.

The examples I have outlined above are only the tip of the iceberg so far as the incursion of foreign government-owned instrumentalities into Australia's productive asset base is concerned.

While government-owned bodies are tightening their grip on the world's natural resources what is Australia doing? Australia is behaving like the village idiot! Not only are our bureaucrats and governments freely allowing the sale of our natural resources to independent foreign companies (for example British Gas buying coal seam methane resources) they are going the whole hog and allowing numerous sales to foreign government-owned entities.

"We welcome Foreign Investment provided that it is in the National Interest"

I have written multiple times to the local federal member about this matter and on two occasions a copy of government policy from Martin Ferguson's office has arrived. It includes wording along the lines of those in the sub-heading above. What I would like to know is what realistic and objective calculations involving actual cash flows have been done to prove that it is in fact in the national interest. Remember too that in order to make those investments pay ultimately more must be taken out by their foreign owners than is put into them. This leads me to my next point.

If this foreign investment is such a great thing why have we always run current account deficits since the advent of deregulation in 1983?

The <u>international acid test of how strong an economy really is</u> is its ability to consistently run current account surpluses. Australia hasn't even looked like doing that for more than twenty-five years. If our governments were private boards of directors they'd have been sacked long ago! Why have we failed? Why, in the years since we breached Paul Keating's 6% "Banana Republic" threshold, has the deficit grown to as high as 7% of GDP? We have had huge amounts of foreign 'investment' in this country and yet we are still running excessive current account deficits. If these investments are so good for the national interest why is that so, even during the massive resources boom which we've had in recent years?

One does not have to look far for the answers. They reside in the components of the current account.

On the trade front we have a continual deficit (a) because we are living beyond our means and borrowing heavily overseas to support our lifestyle and (b) we export low value added and import high value added having gutted much of our manufacturing industry under the spell of the hollow abstractions and prescriptions arising from 'black magic' Rationalist economic ideology. In fact Keating's famous J-Curve was doomed to failure from the outset because we have not invested enough in high value added industries and will never do it while we waste our money on consumer imports.

The key answer to the conundrum, though, lies in the Net Income deficit. Since around 2001 the main driving force behind the deficit has been the Net Income factor. The two key culprits here are Interest Payable on our Net Foreign Debt and Dividends and Royalties flowing to Foreign Owners of Australian assets. In recent times these have accounted for around two-thirds of our deficit on the current account.

On the foreign debt side of things, two things are worth noting:

(i) Our lifestyles are unsustainably built on foreign borrowings. In a letter to Peter Costello in 1997 I warned him about the dangers on several fronts of allowing our banks to borrow overseas to fund housing mortgages and consumption. The chickens have come home to roost. We don't save anymore (although fear is now counteracting this), preferring to let 'overseas others' save for us. In addition our banks have now become heavily, and dangerously, dependent on overseas wholesale sources of funds. If we correct this situation we will find ourselves with far more funds left to invest in our own country.

(ii) When foreign interests buy our assets more often than not they use overseas loans to fund their purchases. In fact, some years ago I took out figures on the indebtedness of foreign-owned companies in Australia versus locally-owned companies. Foreign-owned entities were significantly higher geared. This means that a lot of their profits are exported via interest payments, their taxable income is reduced and they make a significant contribution (via interest payments) to our current account deficit. Is that in Australia's national interest?? The briefest perusal of the Chinese purchases of Australian assets now occurring will show that a lot of the purchase funds are being lent to them by the Chinese government. In the meantime our government doles out stimulus payments so that we can spend them on Chinese imports! It doesn't make sense.

On the foreign ownership side of things, a lot of the profits made will end up being exported as dividends. This helps explain why, in a resources export boom when profits surge, we are not much better off because a lot of the benefit is exported via increased dividends. Add to that transfer pricing and the outgoing interest on foreign borrowings and you have lost much of the benefit of foreign investment. To add insult to injury, as much as 85% of foreign investment is simply purchases of existing assets, rather than greenfield investment. In the mining and oil industries this is rather tragic since it often costs so much local money to find and develop those assets. Some fifteen years ago, when I last looked, it cost around $250m. to find one decent economic copper deposit. What so often happens is that these companies/assets are snapped up, sometimes at firesale prices, by foreign interests before we get any real long-term benefit from them. With the advent of foreign government investment this is accelerating rapidly.

The sad truth about all of the above is that unless you are prepared to save and invest in your own future you cannot expect to prosper. Sitting idly by and allowing outsiders to do the heavy lifting for you will primarily enrich the heavy lifters and leave you a debilitated weakling through lack of exertion.

Operational Issues with Foreign Ownership

With ownership/control of our assets (in particular natural resources) by arms of foreign governments we are likely to get:

(i) Life-of-mine contracts for the output of minerals, etc whereby the products will be sold exclusively to the owner-countries to the exclusion of other buyers. Sales will also tend to occur at discount prices, thus minimising the benefit to Australia. Other countries, including our own, will be denied supply from those sources. This is strategically dangerous, both economically and militarily.

(ii) Use of equipment and expertise imported from the foreign-owner countries as opposed to local sourcing and purchase from other countries. Remember too that in resources industries much of the cost base goes to capital equipment. As opposed to most other industries, a relatively smaller component goes to wages, thus minimising the benefits to Australia. Australian government-imposed covenants requiring that sourcing is local will be complied with for only as long as it takes for the matter to go off the radar screen. Eventually those covenants will be ignored.

(iii) Undermining/manipulation of world metal prices is very likely to occur. Much as the Chinese would like people to believe otherwise, that is one of their primary goals. A Freudian slip by a (Chinese government-appointed) senior official in one of their industry associations recently gave the game away. He inadvertently let slip the fact that the Chinese government was attempting to disrupt a BHP-Rio duopoly and was intent on bringing prices down. Only a naive fool would believe that there is not some form of centrally orchestrated strategic co-ordination between the various government instrumentalities involved. Only an unthinking novice would believe Chinese claims that these government-owned entities are really independent of the Chinese government in their actions.

Issues with Foreign Governments

Dealing with foreign governments is not the same as dealing with private companies. Generally speaking governments have more far-reaching agendas, including resource security, strategic defence considerations and so on. Those considerations may be at odds with Australia's interests, if not now then very likely at some future point in time. Governments, particularly the hard-headed ones like the Chinese, are well aware that gaining control over much of the world's natural resources will confer on them enormous economic and military advantages. Correspondingly it will put their competitors/enemies at a marked disadvantage.

What is even more worrying is that the Chinese government has autocratic, centralist roots and will not hesitate to use military force or other forms of coercion as illustrated by their actions in Tiananmen Square, their suppression of Tibetan dissent and their suppression of Muslims in the province which contains around 25% of China's natural resources. Add to that the brutal treatment of Falun Gong adherents. Should Australians eventually resent Chinese government intrusions into Australian industry and confront the Chinese I have no doubt that they would take whatever tough action suited their interests, including possible invasion. If a democratic country like America has resorted to both covert and overt intervention in other countries' affairs, sometimes with violence, I have not the slightest doubt that China would do the same, probably more readily so.

Another point worth noting is that once a foreign government or its instrumentalities buys our assets it will prove virtually impossible to buy them back, unlike private companies which react in a more purely economic fashion.

"Creeping Takeover" – The "Case-by-case" Approach to Foreign Investment is Flawed

The current approach is to consider each proposition by a foreign acquirer on its merits. While this might sound fair on the surface, it can easily lead to the 'creeping takeover' by foreign interests of Australia's assets. In fact huge slabs of Australia's various sectors are now majority foreign controlled under this regime. These include major food and beverage manufacturing, the car industry, mining and other natural resource industries, media, to name just some. I consider this an absolute national disgrace!

The fact is that the FIRB hardly ever knocks back a request, thus making it extremely difficult to refuse any new request, including those by foreign government bodies.

A system more in the national interest would be to have caps (ceilings) on the level of foreign ownership allowed in the various industry sectors. This is nothing new and has been practised by countries as diverse as Canada, China and Taiwan. In that regard it should be noted that, while China is demanding access to ownership of our assets, it has tightly controlled access to its own natural resources (and other assets) and in fact has increased the difficulty of access in some areas in recent times. Free Trade deals will not solve this problem for Australia. It would be like putting an amateur flyweight in against a champion heavyweight.

Security Issues for Australia

Australia appears to be coasting along oblivious to security issues posed by foreign ownership of its assets, especially natural resources.

One of the key reasons for the demise of societies/civilisations is the loss of natural resources, Easter Island being a prime example. Many of our key resources (e.g. gas) are being exported in massive quantities to benefit other countries. If we let countries such as China and India get control of much of our natural resource base they could 'suck us dry'. They have huge populations and are expanding rapidly and will easily be able to accommodate what can be 'dug out of the ground' here. This would very likely result in price inflation domestically for coal, gas, electricity and so on, especially with life-of-mine contracts on foreign-owned mines and so on. In spite of national security concerns being voiced elsewhere by people such as Britain's Energy Minister, we seem to be coasting along in a fool's paradise, allowing pretty much anyone to take what they want.

Outcomes ignored in favour of Flawed Economic Ideology

It is open slather, rationalist economic ideology which has literally brought the world to the brink of financial disaster. Only now are its serious defects being realised. Having said that, it is astonishing that our bureaucrats and political leaders are still allowing the same ideology to drive our policies on issues such as foreign debt and foreign ownership, including ownership by foreign governments which do not really practice that ideology.

Outcomes such as major current account deficits speak far louder than the flawed and hollow abstractions of a discredited economic ideology. Yet it is the latter that still appears to hold sway.

The elephant in the room is the mismanagement of the Australian economy. Until we reduce our excessive consumption, much of it of imports, start saving, stop borrowing offshore to maintain our lifestyles and start investing in a big way in our own future instead of delegating it to foreign interests we can never become a truly sound economy. The continued permissive attitudes to open slather foreign takeovers of our assets as well as to the stupid practice of borrowing overseas to spend it on our own houses and a vast array of consumer items are only reinforcing our dysfunctional economic behaviour. Yet our government would rather hand control of our precious assets to foreign governments than undertake the necessary corrective actions at home. Quite simply it is a lack of political guts and nous.

In Summary

Allowing foreign government instrumentalities to control Australian assets is even worse than the past practice of allowing open slather purchases by foreign companies which now dominate many of our sectors. Against all predictions based on rationalist economic principles, results have not been as intended, with the inability to run current account surpluses the best single indicator.

Allowing these government instrumentalities to buy and control Australian resources is tantamount to bringing a Trojan Horse into the country. It will prove detrimental and dangerous in both the economic and strategic sense.

At a personal level I am downright disillusioned and disgusted at the supine posture of our governments and bureaucrats that allows the wholesale disposal of our future prosperity.

Bill EDWARDS

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Bill Edwards is a retired investor with, among other things, qualifications in Financial Planning. He has completed the Australian Securities Institute’s (now FINSIA) graduate program in Applied Finance and Investment, winning two State prizes, including one in Advanced Mining Investment Analysis.

PS   Since writing this submission the federal Treasurer has granted permission to Minmetals to purchase many of OZ Minerals’ assets, including their zinc and nickel operations. Its Prominent Hill copper-gold operations have been excluded on the grounds of national security considerations.