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FOR INTERNATIONAL POLICY

PERSPECTIVES

The Changing Global Financial Environment: Implications for Foreign Investment in Australia and China

Outcomes Report

Malcolm Cook and Mark Thirlwell

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The Changing Global Financial Environment:

Implications for Foreign Investment in Australia and China

Outcomes report

Prepared by Malcolm Cook and Mark Thirlwell

A dramatic increase in proposed investment in the Australian resources sector by state-owned Chinese firms is currently confronting Canberra with some tough policy choices as it seeks to balance the national interest, the consequences of the resources boom, and one of Australia's most important bilateral economic relationships. The surge in Chinese investor interest has already prompted the Federal Treasurer to release new guidelines setting out the principles that Australia's foreign investment regime will consider in relation to investment proposals by foreign governments and their agencies that are over and above those that apply to normal private sector proposals.[1] Meanwhile, the Australian press has been filled with reports focused on the policy challenges raised by Chinese investment and the implications of Canberra's response for the health of the bilateral relationship.[2]

On 4 July 2008, the Lowy Institute participated in a half-day seminar on *The Changing Global Financial Environment: Implications for Foreign Investment in Australia and China*.[3] Organised by the Victoria branch of the Australia China Business Council and with the support of Monash University, the seminar canvassed many of the policy issues raised by recent developments. The seminar comprised two panel sessions and concluded with a lunch-time address from the Treasurer, in which Wayne Swan described Australia-China economic relations and outlined Australia's case-by-case approach to evaluating foreign investment applications.[4]

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[1] The press release and the six principles themselves can be found at http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/009.htm&pageID=003&min=wms&Year=&DocType=0.

[2] See for example Matthew Stevens, China faces mining investment curbs, *The Australian*, 26 June 2008 and Glenda Korporaal, China warns Labor on investment curbs, *The Australian*, 2 July 2008.

[3] More information about the event can be accessed at http://www.acbc.com.au/.

[4] This speech can be downloaded at http://www.treasurer.gov.au/DisplayDocs.aspx?doc=speeches/2008/020.htm&pageID=005&min=wms&Year=&DocType=1.

The discussions in Melbourne focused on the interplay of three themes, each a significant and politically sensitive one by itself: the rise of sovereign wealth funds and state-owned enterprise foreign investment; foreign investment in the Australian resource sector during the current resources boom; and growing Chinese outward investment and the Australia-China relationship.

The opening session of the day concentrated on the changing nature of the global economy and international financial markets and the significant role that China's own economic transformation is playing in these developments. The second session looked at the regulatory issues facing Chinese state-owned investors in Australia and Australian private sector investors in China.

The overall sentiment of the half-day seminar was that Australia's existing regulatory system for foreign investment did not need to be bolstered to deal with the new influx of Chinese investment. Instead, consideration should be given to a *more* open approach to foreign investment in general. It was strongly argued that the national interest test for foreign investment should focus on the commercial *use* of a local strategic asset and not on its *ownership*. It therefore followed that competition law and taxation policy (particularly with regard to transfer pricing) were key to guaranteeing a functioning market economy, not foreign investment law.

The global diffusion of wealth

The global economy today is undergoing an historic redistribution of international wealth and power away from the highly unequal world where a small group of Western countries dominated economic activity and were the source of the vast majority of global growth, production and foreign investment. Particularly over the last thirty years, as China and India have begun to open up their economies to the world, global wealth and power is becoming more diffuse and its distribution is moving back towards its historical mean. More recently, the current resource boom has accelerated the redistribution of financial power as oil-exporting states convert crude into financial assets.

Last year, emerging markets accounted for the majority of global growth and major conglomerates from emerging markets are actively investing in developed markets and acquiring major Western firms. By 2002, Mexico's Cemex was the world's third largest cement company, accounting for 11% of global cement trading volume and with a particular focus on rapidly growing (and building) emerging markets. When Mita Steel merged with Arcelor in 2006, after a political backlash in continental Europe, it became the world's largest steel company.[5] Its CEO, Lakshmi Mittal, is rated by Forbes Magazine as the world's richest person. Arcelor Mittal now controls 19.9% of Australia's MacArthur Coal and is rumoured to be looking at Rio Tinto.

This diffusion of wealth away from what had been a North Atlantic-centred world economy is very likely to continue, given the massive populations of the largest emerging markets (8 of the top 10 and 16 of the top 20 countries by population are emerging markets), the continuing globalisation of production and services chains, and the fact that many of the largest emerging markets are still relatively early in their development paths and in opening up to the global economy. Unsurprisingly, given their need for infrastructure and power, the pace with which they are industrialising and urbanising, and the scale of their populations, the ramifications of this redistribution of wealth and power towards major developing economies is most noticeable in rising commodity prices and major investments in resource assets.

This diffusion of wealth and power away from 'the West' poses two political and economic adjustment challenges. First, as we see with the G-8 and in the IMF, major Western countries have a long history of communication about their respective economic policies and commercial activities and the main multilateral economic organisations reflect the traditional concentration of power around the North Atlantic. This bias is increasingly anachronistic but organisational change is slow and difficult.[6] Second, the inflow of emerging market investment into developed economies, particularly when it is in the form of mergers and acquisitions, is a new and growing phenomenon that is sparking local political concern in recipient countries. Both Australia and the United States faced political problems over sharp increases in Japanese foreign investment inflows in the 1970s and 1980s.

Bringing the state back in

As CNOOC and Dubai PortsWorld found out, these local political problems are the most tenacious when the potential acquiring firm is a state-owned or controlled firm. Yet, the diffusion of global wealth and power is intimately tied up with a growing role for state-

[5] For more on the merger and the nationalist backlash, see http://business.timesonline.co.uk/tol/business/article1265304.ece.
[6] See for example Mark Thirlwell and Malcolm Cook, *Geeing up the G-20*, Lowy Institute Policy Brief, April 2006.

controlled capital in global financial markets. Developing economies across the world have typically featured a greater role for the state in the economy overall and for state-owned firms in strategic sectors. This is particularly true for transitional economies like China, Russia and Vietnam (and to a lesser extent India, which is transitioning not from a centrally-planned economy, but from a heavily state-controlled and regulated one).

The resource boom associated with this redistribution is also tied up with this, as many resource exporters are setting up or boosting state investment vehicles to invest the present resource rents for the future, a post-resource future for some of these countries. In the case of East Asia, export-promoting exchange rates have boosted central banks' foreign exchange reserves to such extreme highs that portfolio diversification has become a pressing – and substantial – task. Singapore has been the regional leader in this process of creating new investment vehicles to manage the accumulation of a diversified portfolio of foreign assets, with China and Japan starting to consider similar, if so far comparatively much smaller, moves in this direction.

Sovereign wealth funds (SWFs) are a striking manifestation of this move towards state capitalism and away from the Washington consensus. The twenty largest SWFs are all based either in major resource-exporting countries (including Australia and its growing Future Fund) or in East Asian economies with large stocks of foreign exchange reserves. The IMF estimates that SWFs could grow to control about US$12 trillion by 2012, four times as much (nominally) as they control now. SWFs already control more than hedge funds and private equity ones together but are still significantly smaller than pension funds or mutual funds.[7] The global expansion of major state-owned enterprises like Malaysia's Petronas and CNOOC, often in response to rising resource prices and resource security concerns, is another new dimension in the global economy.

This shift poses a fundamental challenge to policymakers in the developed word. On the one hand, they have spent much of the past three decades explaining to their voters that private businesses, not governments, should run most of their economies. On the other, they have also typically been strong advocates of the benefits associated with openness to foreign investment. When confronted with government-controlled foreign investment, one of these two propositions has to give. The challenge facing policymakers is, which one?

[7] Statistics taken from A. Stoeckel, *Sovereign wealth funds: friend or foe,* Canberra, Centre for International Economics, 2008. This paper was written for this seminar.

The view of the majority of speakers at the seminar seemed to be that the ownership constraint should be the one to be relaxed, rather than the commitment to openness to foreign investment. In particular, several speakers argued that government ownership was irrelevant, and that what mattered was the presence of effective competition laws, taxation regimes and other suitable regulatory frameworks.[8] However, a minority view (presented by one of the Lowy Institute speakers) was that there would remain some cases where government ownership would raise difficulties. For example, allowing a foreign government that restricted the freedom of the press at home to own extensive media holdings in Australia would clearly be very problematical.

The China connection

China is the central country in this historic change in the global economy and its implications for global financial and commodity markets. China is not only, by far, the *largest* emerging market, it has also been the *fastest growing* major economy for the last three decades with many, including Treasurer Swan, believing that this growth will continue. Last year, China accounted for a larger share of total world growth than the United States. As a transitional economy still ruled by the Chinese Communist Party, the state still plays a very significant role in the Chinese economy and its integration globally and this is unlikely to change in the foreseeable future.

The combination of China's massive size (already the second-largest economy in the world by purchasing power parity), rapid growth and the important role of its state-owned enterprises and state-owned banks, and its new SWF, all feature heavily in China's growing role as a source of foreign investment. Prior to 1991, Chinese foreign investment was negligible. Since 2000 though and the launch of the 'Going Out' foreign investment strategy, the Chinese state has provided significant support for Chinese firms to invest overseas to gain access to sources of supply, new markets and greater organisational capabilities. China's 150 state-owned 'central enterprises', that together control three-quarters of the listed companies in China, have been at the forefront of this strategy.

[8] A slight modification of this view was that government ownership was not problematic provided that the government in question was foreign (since there was no conflict of interest in the same government being both regulator and owner). While this is may be a way to deal with the dilemma posed above, *politically* the argument that foreign governments are fine, but one's own government should be suspect, is probably a difficult one to sell.

In 2007, China's overseas investment flows (excluding Hong Kong SAR) equalled about 0.8% of its GDP, the same ratio as Japan and much lower than the United Kingdom at 15.5%. However, given the size of China's economy, 0.8% of GDP is still substantial. An estimated 44% of China's overseas mergers and acquisitions from 1995 to 2007 have been in Asia and 33% in the oil and gas sector. 30% has been in financial services and only 9% in mining or metal and steel.[9]

China's overseas investment is much more of a state-owned enterprise story than a SWF one, despite the present global focus on SWFs. The $200 billion Chinese Investment Corporation is China's major SWF. Yet, two-thirds of its investment portfolio is expected to be targeted at recapitalising the *domestic* financial sector with only one-third for investment overseas, mostly through private fund managers. The UAE (via ADIA) and Singapore (via GIC and Temasek) are much larger SWF players than China.

The Australia connection

While China is the major player in this story, Australia's economy and its position in the world are being reshaped by these same global forces. As noted by the Treasurer, the shift of global wealth and power away from the North Atlantic to the Pacific means that Australia is no longer geographically peripheral; distance is no longer so tyrannical. The diversification and growth in foreign investment is also good for Australia, given our very long run of significant current account deficits. One speaker paraphrased the wry joke that Australia had only witnessed two current account surpluses since 1788, the year the First Fleet arrived. Yet, while Australia is a country dependent on foreign investment, it has one of the most restrictive regulatory frameworks for foreign investment in the OECD. In 2006, the OECD, using a methodology developed by Australia's Productivity Commission, ranked Australia the second most restrictive towards foreign investment among OECD countries after Iceland.[10] China is roughly one and a half times as restrictive as Australia using this same methodology.

As the Treasurer reiterated in his speech, Australia's foreign investment rules, established more than 30 years ago, for applications to buy 15% or more of a local firm (or raise an

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[9] These figures come from McKinsey Consulting and were contained in Professor On Kit Tam's presentation to the seminar. Professor Tam is from Monash University.

[10] Op cit, Stoeckel. Note, however, that the index is subject to a number of limitations. For example, as the OECD itself acknowledges, it only takes formal, overt regulatory restrictions into account, and does not factor in non-policy institutional or informal restrictions. In the seminar discussions about Australian investment in China, it was noted that informal barriers to investment are often as important as the formal ones.

existing stake to 15% or more) take particular notice of applications from state-owned or controlled entities. During the seminar, participants also noted, with eyebrows raised, that even bids for less than 15% by state-owned or controlled entities are also encouraged to apply to the Foreign Investment Review Board for approval.

China's investment in Australia is growing very rapidly from a small base. In 2006, the stock of Chinese investment in Australia was about $3.5 billion, while last financial year investment applications rose to $10 billion and this year may hit $30 billion. The Treasurer noted that since coming to power in late November 2007, he had approved a Chinese investment application on average once every nine days. At the same time, there is concern within the investment community and the broadsheets about reported delays in the processing of Chinese investment applications. In part, these concerns reflect the memories of the Australian response to the rapid growth in Japanese foreign investment in the 1970s to 1980s that led to the passing of the 1975 Foreign Acquisitions and Takeovers Act that established the present regulatory framework for foreign investment across the board, including in real estate.

Managing Australia's mineral wealth

Australia's resource sector has been a major beneficiary of the diffusion of global wealth and power, and its share in the total Australian economy is growing as is its contribution to the tax take. Unsurprisingly, the majority of China's investment interest in Australia to date is in this sector and particularly in iron ore. Last year, Australia supplied close to 40% of China's iron ore imports, and the volume of these imports is expected to double by 2012. China is the world's largest steel producer, accounting for more than a third of total global steel production and demand.

China's first foreign investments in the 1980s in Australia were in the mining sector as is its largest to date, Chinalco's US$14 billion purchase of 9% of Rio Tinto this year. The Chinalco bid was not only the largest Chinese investment in an Australian company by far, it did not follow the hitherto traditional joint venture path. Rather, it was a direct investment. Sinosteel's recent purchase of Midwest in Australia also followed this route. To date, Sinosteel's purchase of a majority stake in Midwest is the largest overseas metals takeover by a Chinese state firm.

Chinese state-owned firms' growing interest in Australia, the shift to direct investments, and the moves beyond smaller tier-two or tier-three Australian firms have raised the question of whether the existing regulatory framework for foreign investment is adequate or if it requires reform.

Here, the seminar reached a clear conclusion. A strong consensus emerged from the two sessions preceding the Treasurer's speech to the effect that the current regime *already* provided Canberra with all of the tools required to manage new inflows of investment. Indeed, several speakers argued that the current regime was in fact too restrictive, not too lenient. During the question period after the Treasurer's speech, the Treasurer strongly disagreed with this argument.

The Changing Global Financial Environment: Foreign Investment in Australia & China

An Australia China Business Council Forum
in collaboration with
The Lowy Institute for International Policy and
Faculty of Business and Economics, Monash University
Friday July 4th, 2008, 7.30am – 2.30pm
Venue: The Langham Hotel, Southbank Melbourne

Update 2/07/08
PROGRAM TIME SCHEDULE FOR CHAIRS, SPEAKERS, PARTICIPANTS

7.30- 8.00 am	**Registration**
Session 1	**The New International Financial Environment: Policy & Practice**
8.05am – 8.15am	**Welcome: Lyall Howard**, President ACBC in Victoria, Manager Government & Corporate Relations, Rio Tinto Limited
8.15am – 8.25am	**Forum Opening: The Rt Hon Lord Mayor John So**
8.25am – 8.30am	**Session Intro**: **Toni Feddersen**, Executive Director ACBC Victoria
8.30am– 8.40am	**Session Chair & Moderator: Dr Malcolm Cook,** Program Director East Asia, Lowy Institute for International Policy
8.45am– 9.00am	**Mark Thirlwell,** Program Director - International Economy, Lowy
9.00am– 9.15am	**Dr Andrew Stoeckel,** Executive Director, Centre for International Economics
9.15am– 9.30am	**Prof. On Kit Tam,** Faculty of Business and Economics, Monash University
9.30am– 10.00am	**Moderated Discussion / canvassing of views : Chair**
10.00am– 10.30am	**Morning break**
Session 2	**Implications for Foreign Investment China & Australia**
10.35am – 10.45am	**Session Chair & Moderator: Ian McCubbin** National Leader China Business, Deacons Lawyers & National Vice-President of ACBC
10.45am – 11.00 am	**Hong Xiao Yuan,** CEO China Merchants Finance Holdings Co., Ltd
11.00am – 11.15am	**Dr Bob Edgar,** Senior Managing Director, Australia and New Zealand Banking Group Ltd
11.30am – 11.45am	**Robin Chambers,** Senior Partner, Chambers Lawyers, non-executive director Sinosteel Australia Pty Ltd, Wuhan Steels Aust. subsitidary, YTC Resources.
11.45 am – 12.15pm	**Moderated Discussion / canvassing of views: Chair**
12.15pm- 12.25pm	**Forum Summary**: **Dr Mark Crosby, Consultant to ACBC**
12.30	Guests move to Ballroom for Lunch

Session 3	**Luncheon Address**
12.30	Corporate table guests arrive for 12.45 start. Forum guests move to ballroom B & C.
12.45 pm	Session Introduction: **Toni Feddersen**, Executive Director ACBC Victoria
12.50	Main Course served
1.00pm	Session Chair and Introduction of Treasurer: **Lyall Howard** President ACBC Victoria
1.05pm	**Luncheon Address:** **The Australian Federal Treasurer: The Hon Wayne Swan MP**
1.30pm	Questions
	Dessert Served
1.50pm	Chair introduces **Jason Chang KPMG** for the Vote of Thanks
2.00 pm	**Lyall Howard** President ACBC Victoria draws meeting to conclusion
2.10pm	Treasurer leaves for airport

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