

Is the Foreign Investment Review Board acting fairly?

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**AUSTRALIA'S
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Australia's foreign investment regime is once again the subject of controversy. In the past, high profile bids by Shell for Woodside (in 2001, blocked by then Treasurer Peter Costello) and by Xstrata for WMC Resources (in 2005, approved by Treasurer Costello with conditions) have attracted a great deal of controversy. This year, Treasurer Wayne Swan has been grappling with a surge of Chinese investment into the Australian resources sector.¹ Meanwhile, a general protectionist drift in global Foreign Direct Investment (FDI) policy has emerged at the international level.²

Asking the right question

We have been asked the question, 'Is the FIRB (Australia's Foreign Investment Review Board) acting fairly?' One way to answer that question is to ask whether Australia is living up to its international commitments with regard to foreign investment. The Organisation for Economic Cooperation and Development (OECD), of which Australia is a member, has been at the forefront of efforts to develop international 'rules of the game' for foreign investment and promote fair treatment of foreign investors. The OECD's general investment policy principles are established in the OECD's investment instruments, based on the OECD Code of Liberalisation of Capital Movements (1961) and the OECD Declaration on International Investment and Multinational Enterprises (1976, revised in 2000).³ It is then possible to assess Australia's regime against those principles. However, we think framing the current policy debate in terms of 'fairness' is problematic for at least two reasons.

First, from the point of view of the integrity of the investment regime, 'fairness' is a strange test to set the FIRB. Fairness to whom? To shareholders and/or managers in the companies that are targets of foreign takeovers? To the foreign companies themselves? To Australian citizens? Or all of the above? What happens if being fair to one group of stakeholders means being 'unfair' to another? A better alternative might be to evaluate the FIRB in terms of the stated objective of Australia's foreign investment framework: to protect the national interest.

Second, in practice the FIRB is only one component of Australia's investment framework. Indeed, the Board's functions are advisory only, with responsibility for the government's foreign investment policy overall – as well as for making decisions

¹ See for example Matthew Stevens, China faces mining investment curbs. *The Australian*, 26 June 2008. Also Glenda Korporaal, China warns Labor on investment curbs. *The Australian*, 2 July 2008.

² David M Marchick and Matthew J Slaughter, *Global FDI policy: Correcting a protectionist drift*. Council Special Report No. 34. New York, Council on Foreign Relations, 2008.

³ The five key principles are (1) non discrimination (foreign investors are to be treated not less favourably than domestic investors in like situations); (2) transparency; (3) progressive liberalisation; (4) standstill (no new restrictions); (5) unilateral liberalisation. See <http://www.oecd.org/dataoecd/0/23/41456730.pdf>

on individual proposals - resting with the Treasurer.⁴ Ultimately, it is Wayne Swan who has to make the call as to whether a project will go ahead.⁵

These two qualifications argue for a somewhat different question, along the lines of *Can Australia's existing foreign investment regime ensure that Chinese investment in our resources sector is in the national interest?*

The short answer to this question is, yes it can. The longer answer involves the consideration of several elements, including:

- the nature Australia's foreign investment framework in general, and its treatment of government-controlled foreign investment in particular;
- the degree of restrictiveness of Australia's investment framework;
- the concept of the national interest;
- the global context within which Australian investment policy has to operate;
- and the specific context provided by the Australia-China bilateral relationship.

Australia's foreign investment framework

Foreign investment in Australia is regulated under the Foreign Acquisitions and Takeovers Act 1975 (the FATA) and by the Australian Government's Foreign Investment Policy (the Policy).⁶ The Australian Government's approach is to encourage foreign investment consistent with community interests. The Policy acknowledges up front community concerns about foreign ownership of Australian assets.⁷ So one important objective of the Policy is to balance community concern about foreign ownership of Australian assets against what the government recognises as the '*strong economic benefits*' that the economy receives from foreign investment.

The Policy provides the framework for Government scrutiny of proposed foreign investment while the FATA, together with the Foreign Acquisitions and Takeovers Regulations 1989, sets out which types of foreign investment proposal require notification to or prior approval by the Government, and provides monetary thresholds below which the relevant FATA provisions do not apply.⁸ In addition to

⁴ See <http://www.firb.gov.au/content/who.asp?NavID=48>

⁵ The Treasurer has provided an authorisation (effectively a delegation) to the Executive Member of the FIRB and other senior staff at Treasury's Foreign Investment and Trade Policy Division to make decisions on foreign investment proposals that are consistent with the Policy or do not involve issues of special sensitivity. Around 94% of proposals are decided under this authorisation, predominantly in the real estate sector. Foreign Investment Review Board, *Annual Report 2006-07*. Canberra, 2008.

⁶ Greg Golding and Rachael Bassi, *Australian regulation of investments by Sovereign Wealth Funds and State Owned Enterprises*. Paper presented at the conference "Sovereign Wealth Funds in an Evolving Global Financial System" held at the Lowy Institute on 25-26 September 2008 and organised by the Lowy Institute and the Centre for Applied Macroeconomic Analysis in the Australian National University College of Business and Economics. Sydney, 2008.

⁷ Australian Treasury, *Summary of Australia's foreign investment policy*. Canberra, Foreign Investment Policy Division, The Treasury, April 2008.

⁸ Foreign investment proposals subject to the FATA include acquisitions of substantial interests in an Australian business where the value of its gross assets exceed A\$100 million; proposals to establish new businesses involving a total investment of A\$10 million or more; and takeovers of offshore companies whose Australian subsidiaries or gross assets exceed A\$200 million. A substantial interest occurs when a single foreigner (and any associates) has 15% or more of the ownership or several foreigners (and any associates) have 40% or more in total of the ownership of a corporation, business or trust. As a result of the Australia-United States Free Trade Agreement (AUSFTA), US investors are subject to somewhat higher thresholds than investors from the rest of the world: for example, instead of

the reporting requirements under the FATA, the Policy also imposes additional restrictions on investments by foreign persons in sensitive sectors including banking, civil aviation and airports, shipping, telecommunications and the media.

The FIRB assists the Federal Treasurer exercise his responsibilities for making decisions relating to foreign investment and for administering the Policy. It examines proposals by foreign interests to undertake direct investment in Australia, and makes recommendations to the government on whether those proposals are suitable for approval under the Policy.⁹ The FIRB is an administrative body with no statutory existence, and the FATA makes no reference to it. Instead, its role is confirmed by the Policy.¹⁰

The requirement for prior approval for larger or more sensitive transactions is intended to allow the Treasurer to assess, on a case-by-case basis, foreign investment proposals against the criterion of the national interest. The FATA does not define the national interest, however, and the Policy merely states that the Government determines what is contrary to the national interest by '*having regard to the widely held community concerns of Australians*'. The legislative intent therefore seems to have been to leave considerable discretion to the Government in defining the national interest.

Dealing with foreign government investment

Particularly important in the context of the current debate over Chinese investment is the stance that the Policy takes towards investment by foreign governments. It requires prior notification in the case of all investments by foreign government, regardless of the size of the proposal – implicitly recognising that this type of investment raises particular issues and community sensitivities.

Before 17 February 2008, the guidance offered by the Policy on this issue was quite brief, stating only that '*All direct investments by foreign governments or their agencies irrespective of size are required to be notified for prior approval . . . whether the investment is made directly or through a company that is owned 15% or more by a foreign government.*'¹¹ On 17 February 2008, however, the Treasurer released a new set of guidelines for foreign government investment proposals – against a backdrop of growing media attention on Chinese investment applications in the resources sector.

A\$100 million, US investors face a threshold of A\$105 million for investments in prescribed sensitive sectors (or for investments by an entity controlled by the US government) and a threshold of A\$913 million in any other case. The AUSFTA sensitive sectors are set out in Attachment C in The Australian Treasury, *Summary of Australia's foreign investment policy*. Canberra, Foreign Investment Policy Division, The Treasury, April 2008

⁹ This account is taken from the description on the FIRB's own web site, at <http://www.firb.gov.au/content/who.asp?NavID=48>. According to this description, the five functions of the FIRB are: (1) to examine proposals by foreign interests for investment in Australia and make recommendations to government on those proposals; (2) to advise the government on foreign investment matters generally; (3) to foster an awareness, in Australia and abroad, of the government's foreign investment policy; (4) to provide guidance where necessary to foreign investors; and (5) to monitor and ensure compliance with foreign investment policy.

¹⁰ Golding and Bassi, *Australian regulation of investments by Sovereign Wealth Funds and State Owned Enterprises*,

¹¹ *Ibid.*,

The new guidelines state that while proposed investments by foreign governments and their agencies would be assessed on the same basis as private sector proposals, the fact that these investors were owned or controlled by a foreign government raised 'additional factors that must also be examined' given that 'investors with links to foreign governments may not operate solely in accordance with normal commercial considerations and may instead pursue broader political or strategic objectives that must also be examined.'¹² The Treasurer listed six issues that would be examined when considering proposed investments by foreign governments and their agencies. The Treasurer will look at the extent to which:

1. An investor's operations are independent from the relevant foreign government.
2. An investor is subject to and adheres to the law and observes common standards of business behaviour.
3. An investment may hinder competition or lead to undue concentration or control in the industry sectors concerned.
4. An investment may impact on Australian government revenue or other policies.
5. An investment may impact on Australia's national security.
6. An investment may impact on the operations and directions of an Australian business, as well as its contribution to the Australian economy and broader community.

In addition, some commentators have claimed to have detected a seventh criterion relating to proposed investments aimed at vertical integration.¹³ In a speech given in July 2008, the Treasurer noted that 'our predisposition is to more carefully consider proposals by consumers to control existing producing firms.'¹⁴

How restrictive is Australia's foreign investment regime?

This foreign investment regime has been the subject of a fair degree of criticism, often relating to a perceived lack of transparency and the alleged vagueness of the 'national interest' criterion. For example, the *Financial Times* newspaper, writing in reference to Xstrata's 2005 bid for WMC Resources, editorialised that 'Other developed countries, including the US, screen inward investments. But few operate regimes that are more opaque, unaccountable or open to political and bureaucratic manipulation.'¹⁵ The same editorial went on to argue that the national interest test was a 'criterion so vague as to justify almost anything' and concluded that Australia's

¹² Attachment A in The Australian Treasury, *Summary of Australia's foreign investment policy*,

¹³ See for example Peter Gallagher, Arbitrary approvals hurt us all. *Australian Financial Review*, 26 August 2008. Drysdale and Findlay argue that this step increases the restrictiveness of access to the resource sector by foreign participants. Peter Drysdale and Christopher Findlay, *Chinese foreign direct investment in Australia: Policy issues for the resource sector*. Paper for presentation to Crawford School Public Seminar, Crawford Building, Australian National University, 4 September 2008. Canberra, 2008.

¹⁴ Wayne Swan. *Australia, China and this Asian Century*. Speech to the conference "The changing global financial environment: Foreign investment in Australia and China", an Australia China Business Council Forum in collaboration with The Lowy Institute for International Policy and the Faculty of Business and Economics, Monash University. Melbourne, 4 July 2008.

¹⁵ Financial Times Editorial Comment, Scrap the Fibr. *Financial Times*, 10 February 2005. For a more recent Australian critique, see for example Gallagher, Arbitrary approvals hurt us all.

system was a ‘*protectionist relic.*’ More recently, a report by consultants ITS Global argued that Australia’s regulatory regime is imposing significant economic costs by delaying some foreign investment and prompting the withdrawal of other proposals.¹⁶

Do these criticisms stack up?

One approach to answering this question is to look at the data provided by the FIRB itself. In 2006-07, 7,025 applications for foreign investment were considered under the Policy and the FATA. Of those, 200 were exempt or not subject to the FATA, 629 were withdrawn, and 6,157 were approved (Table 1). Just 39 were rejected. Of the foreign investment applications decided (proposals either approved or rejected), basically 100% were approved by value (Table 2).¹⁷

Table 1: Foreign investment applications considered by the FIRB 2001/2-2006/7						
<i>By number of proposals</i>						
	2001-2	2002-3	2003-4	2004-5	2005-6	2006-7
Proposals considered	5,097	5,315	5,036	4,884	5,781	7,025
% of total	100	100	100	100	100	100
Approved unconditionally	1,041	1,105	995	1,127	1,386	1,520
% of total	20.4	20.8	19.8	23.1	24.0	21.6
Approved with conditions	3,405	3,562	3,452	3,233	3,800	4,637
% of total	66.8	67.0	68.5	66.2	65.7	66.0
Total Approved	4,446	4,667	4,447	4,360	5,186	6,157
% of total	87.2	87.8	88.3	89.3	89.7	87.6
Rejected	77	80	64	55	37	39
% of total	1.5	1.5	1.3	1.1	0.6	0.6
Withdrawn	402	365	319	287	373	629
% of total	7.9	6.9	6.3	5.9	6.5	9.0
Exempt	172	203	206	182	185	200
% of total	3.4	3.8	4.1	3.7	3.2	2.8

Source: Derived from Table 2.1 in Foreign Investment Review Board, *Annual Report 2006-07*. (2008)

Table 2: Foreign investment applications decided, 2001/2-2006/7						
<i>By A\$ billions</i>						
	2001-2	2002-3	2003-4	2004-5	2005-6	2006-7
Proposals decided	118.0	85.8	99.1	119.5	85.8	156.4
% of total	100	100	100	100	100	100
Approved unconditionally	70.2	53.5	58.9	60.4	72.5	140.3
% of total	59.5	62.4	59.4	50.5	84.5	89.7
Approved with conditions	47.7	32.2	40.1	59.1	13.3	16.1
% of total	40.4	37.5	40.5	49.5	15.5	10.3
Total Approved	117.9	85.7	99.0	119.5	85.8	156.4
% of total	99.9	99.9	99.9	100.0	100.0	100.0
Rejected	0.1	0.0	0.1	0.0	0.0	0.0
% of total	0.1	0.0	0.1	0.0	0.0	0.0

Source: Derived from Table 2.2 in Foreign Investment Review Board, *Annual Report 2006-07*. (2008)

¹⁶ Using 2006-07 data they estimate the economic cost of delayed investment at around A\$4 billion a year and the economic cost of withdrawn investment of A\$1.5 billion a year for a total cost of A\$5.5 billion, or a little over ½% of GDP. ITS Global, *Foreign Direct Investment in Australia - the increasing cost of regulation: Report by ITS Global*. Melbourne, 9 September 2008

¹⁷ Foreign Investment Review Board, *Annual Report 2006-07*,

On the face of it, then, the FIRB data suggest that the investment review process is not particularly restrictive. However, the data do not really allow us to make this assessment, mainly because we do not know how much investment was not submitted for review that would otherwise have flowed into Australia if it had not been discouraged by the prevailing investment regime.

A slightly different approach is to look at measured *outcomes* in terms of Australia's receipt of inward FDI – such as the country's ranking in global foreign investment inflows. On these measures, Australia does not stand out as an obvious outlier in the way that (say) Japan does. So, for example, ranking countries based on the stock of inward Foreign Direct Investment (FDI) as a share of GDP shows Australia placed around the middle of the pack (Figure 1).¹⁸ However, comparisons of gross FDI inflows or of FDI as a share of GDP do not take into account other factors that might be expected to influence investment including resource endowments, trade barriers and geographical location along with the FDI regulatory environment and the general regulatory environment. For example, one alternative measure which is sometimes cited is UNCTAD's Inward FDI performance index, which ranks countries by the FDI they receive relative to their economic size. It is the ratio of a country's share in global FDI inflows to its share in global GDP.¹⁹ Australia ranks a lowly 131 out of 141 in these rankings. But a glance at some of the countries ranked above Australia suggests that this may not be a particularly helpful measure of Australia's attractiveness as an investment destination: it seems unlikely that Canberra should be seeking to create the investment environment of a Moldova (#19) or a Congo (#33).

Looking at outcomes tells us nothing about a potentially important counterfactual – that is, how foreign investment into Australia might have performed given a different (more liberal) regulatory regime – and hence by implication how the current regime may be altering Australia's relative attractiveness as an investment destination.

One of an extremely small number of studies to attempt this kind of analysis finds that efforts by Australia to reduce its prevailing restrictions on FDI down to the levels prevailing in the United Kingdom would lead to a significant increase in the stock of inward FDI.²⁰ Another attempt to carry out this kind of assessment was conducted with reference to the easing of investment restrictions produced by the AUSFTA. Modelling by the Centre for International Economics, commissioned by the Government, suggested that by raising the notification threshold for US investors in Australia, AUSFTA would not only reduce transactions costs for US investors, but could also contribute to a reduction in the equity risk premium. This in turn was estimated to produce substantial economic gains for Australia, implying that the

¹⁸ FDI data are from UNCTAD, *World Investment Report 2008: Transnational corporations and the infrastructure challenge*. Geneva, United Nations Conference on Trade and Investment, 2008.

¹⁹ The methodology for the index is available at <http://www.unctad.org/Templates/WebFlyer.asp?intItemID=2469&lang=1> and country rankings are available at <http://www.unctad.org/Templates/WebFlyer.asp?intItemID=2471&lang=1>

²⁰ The measure of FDI restrictiveness is the OECD indicator discussed below. It should also be noted that these kinds of simulations are subject to a number of limitations, including the assumption that changes in policies do not change the estimated average relationships (the Lucas critique) and that the average cross-country relationships are representative of relationships in each country. Giuseppe Nicoletti, Stephen S Golub, Dana Hajkova, Daniel Mirza and Kwang-Yeol Yoo, *The influence of policies on trade and foreign direct investment*. OECD Economic Studies No. 36. Paris, Organisation for Economic Cooperation and Development, 2003. See note 60.

existing restrictions might impose significant economic costs in terms of foregone economic welfare.²¹ The approach taken by the CIE is controversial, however, and other analysts have argued strongly that treating the change to the FIRB screening process as producing a change in the risk premium is inappropriate; instead, any estimated gains should be restricted to the (far more modest) consequences of the associated decline in transactions costs.²²

In the absence of any clear results on the cost of existing restrictions, general surveys of overall investment attractiveness or investment climate tend to show Australia stacking up reasonably well in international terms. So, for example, the 2007 A T Kearney FDI Confidence Index – which surveys executives from companies that together account for about 75% of global FDI flows – ranks Australia in a fairly creditable eleventh place, albeit down from eighth place in 2005 (Figure 2).²³ A more recent survey by UNCTAD looking at the FDI intentions of the world's leading transnational corporations ranks Australia as the ninth most attractive destination in the world for FDI.²⁴ Similarly, Australia scores quite well on the Heritage Foundation's 'Investment Freedom' index, receiving a score of 80 out of a maximum possible score of 100 (Figure 3).²⁵ Such measures suggest room for improvement, but no drastic failings.

In contrast, a much more negative picture comes from the OECD's FDI regulatory restrictiveness index. This covers 9 sectors (although *not* the resource sector) and 11 sub-sectors and seeks explicitly to measure deviations from 'national treatment' – that is, discrimination against foreign investment.²⁶ According to the OECD, Australia's investment regime is one of the most restrictive of any OECD members, and is also restrictive compared to that prevailing in a number of non-members as well: out of the 43 countries ranked by the OECD's index, Australia is categorised as the sixth most restrictive (Figure 4).²⁷

²¹ See CIE, *Economic analysis of AUSFTA: Impact of the bilateral free trade agreement with the United States*. Canberra, Centre for International Economics, April 2004.

²² See for example Philippa Dee, *The Australia-US Free Trade Agreement: An Assessment*. Pacific Economic Papers No. 345. Canberra, Australian National University, 2005.

²³ The survey was conducted in July-August 2007. A T Kearney, *New concerns in an uncertain world: The 2007 Foreign Direct Investment Confidence Index*, 2008.

²⁴ The survey was conducted between April and June 2008. UNCTAD, *World Investment Prospects Survey: 2008-2010*. Geneva, United Nations Conference on Trade and Investment, 2008.

²⁵ The score is a 'measure of the free-flow of capital, especially foreign capital' and is graded on a 0 to 100 scale, where 100 represents the maximum freedom. The Heritage Foundation, *2008 Index of Economic Freedom: The link between opportunity and prosperity*. Washington DC, The Heritage Foundation and The Wall Street Journal, 2008.

²⁶ Restrictiveness is measured on a 0-to-1 scale, with 0 representing full openness and 1 a prohibition of FDI. OECD, OECD's FDI regulatory restrictiveness index: Revision and extension to more economies and sectors, in *International investment perspectives: Freedom of investment in a changing world*. Paris, Organisation for Economic Cooperation and Development, 2007.

²⁷ There are several important qualifications regarding the extent to which these OECD scores capture accurately the overall regulatory environment facing foreign investors. In particular, the measures are limited to overt regulatory restrictions, and as such ignore a potential range of institutional or informal restrictions, such as the nature of corporate governance. They also exclude other policies that indirectly impinge on FDI, including economic and social regulation. The degree of actual enforcement of statutory restrictions is not included in the scores. Finally, the OECD notes that it is possible that some countries may be more open in reporting their restrictions than others, implying that more transparent countries may receive higher scores than non-transparent ones. *Ibid*.

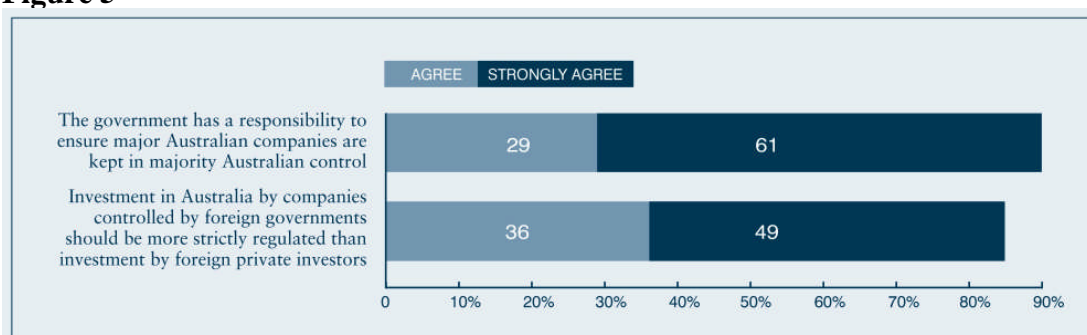
Defending and defining the ‘national interest’

We noted above that one criticism levelled at Australia’s investment regime is the reliance on a ‘vague’ national interest test. The ITS Global report cited above, for example, stresses that neither the FATA nor the FIRB provides any guidance as to how the national interest is to be defined. It argues that this means that ‘*the only substantive constraint on the Government’s handling of foreign investment issues is the requirements for democratic accountability, as expressed through the Australian Parliament. This makes all foreign investment issues inherently political . . . foreign investment policy will tend to reflect the views of the median voter, regardless of how much the median voter knows about foreign investment or the economic trade-offs that are involved in restricting it.*’ The result, the report argues, is a high level of political uncertainty that discourages foreign investors.

We have already addressed the issue as to whether Australia’s foreign investment framework is discouraging capital inflows. We would also differ with the contention that the only constraint facing the government is the Australian Parliament. Australia runs large current account deficits which require external financing, and has done so for nearly all of its history. This means that no Australian government can afford to pursue policies that will scare off foreign investors *en masse*. While acknowledging community concerns the Policy makes clear in its first line that its aim is to encourage foreign investment.²⁸

More fundamentally, however, this assessment is mistaken in the assumption that a change to the national interest criterion would somehow remove politics from the equation when it comes to foreign investment. Despite the clear economic benefits of openness to investment flows, foreign investment is a sensitive domestic issue. *The Lowy Institute Poll 2008* (conducted in July) found that 90 per cent of Australians either ‘strongly agree’ or ‘agree’ that that the government has a responsibility to ensure major Australian companies are kept in majority Australian control (Figure 5).²⁹ There was also overwhelming agreement (85 per cent) that investment by companies controlled by foreign governments should be more strictly regulated than investment by foreign private investors.

Figure 5



Source: Hanson, *Australia and the World: Public Opinion and Foreign Policy. The Lowy Institute Poll 2008*. (2008)

²⁸ Australian Treasury, *Summary of Australia's foreign investment policy*,

²⁹ Fergus Hanson, *Australia and the World: Public Opinion and Foreign Policy. The Lowy Institute Poll 2008*. Sydney, Lowy Institute for International Policy, 2008

Several important implications flow from this.

The first is that no government, no matter how supportive of foreign investment, is going to give up its discretion to review potentially sensitive foreign investment proposals. This is a simple political reality, and applies particularly to applications by government-controlled entities such as state-owned enterprises or Sovereign Wealth Funds (SWFs): ‘While SWFs are not new, as they grow in size and importance it seems inevitable that their activities will be subject to increasing scrutiny by the governments and citizens of the countries in which they invest.’³⁰

Nor is this reality confined to Australia. According to Devlin and Brummitt, the German government is reportedly considering legislating to block state-controlled foreign investments; the European Commission is inquiring into whether state-controlled investment funds from Russia, China and the Middle East threaten Europe’s single market; and the United States has revised legislation governing its Committee on Foreign Investment in the United States.³¹ This follows the high profile Dubai Ports World and CNOOC/Unocal cases. In that sense the Australian public mood seems to be part of a broader upsurge in investment protectionism, to be discussed below.

Second, rather than dismissing parliamentary accountability as a constraint on foreign investment we would argue that it is legitimate and appropriate for the elected government of the day to be charged with defining the national interest. There should be as much transparency and accountability as possible built into the process. But we would argue that the level of public scrutiny of proposals currently before the FIRB is considerable and that in a rapidly changing international investment environment trying to tie the Treasurer’s hands by seeking to codify the national interest would be difficult to achieve and potentially counterproductive. Charging unelected officials with this responsibility certainly does not seem an improvement.

Third, given these political realities supporters of an open investment framework should recognise that sustaining public tolerance for the system overall – a system which approves the overwhelming majority of applications – requires that Government is able to reassure the public that a rigorous process of scrutiny is in place. While this entails an overhead, that may be the price that has to be paid to maintain the credibility and integrity of a relatively open investment regime that is essential for meeting Australia’s enduring need for foreign capital.

The national interest and national security

One important component of the national interest is national security.

³⁰ Will Devlin and Bill Brummitt, *A few sovereigns more: The rise of Sovereign Wealth Funds*. Canberra, Australian Treasury, 2007

³¹ *Ibid.*,

The international investment framework recognises that protecting national security is a legitimate concern for and responsibility of national governments. Article 3 of the OECD Code of Liberalisation of Capital Movements provides that:³²

The provisions of this code shall not prevent a Member from taking action which it considers necessary for:

- i) the maintenance of public order or the protection of public health, morals and safety;*
- ii) the protection of its essential security interests;*
- iii) the fulfilment of its obligations relating to international security.*

This principle is reflected in Australia's national investment framework. The *Guidelines for Foreign Investment Proposals* recognise that:

5. *An investment may impact on Australia's national security.*

*The Government would consider the extent to which investments might affect Australia's ability to protect its strategic and security interests.*³³

Critics of investment controls argue that the national security exception is a back-door protectionist device, and there is *some* evidence for that. Strikingly, nearly all of the restrictions to international foreign investment regimes imposed in recent years have been justified in terms of national security.³⁴ So how serious is the threat posed to national security by foreign investment – particularly investment by entities controlled by foreign governments?

The answer depends somewhat on the nature of the threat.

Some investments pose a direct and fairly obvious threat to national security. These include attempts to acquire Australian companies in which reside technologies, capabilities, knowledge or other information that are important to our national security.

A good example is the 2001 acquisition by Singapore Telecom (SingTel), a telecommunications company partly owned by the Singapore government, of Optus (then majority owned by Cable & Wireless). In that case the deal proceeded, but only after a significant delay in the FIRB review process while the companies involved worked to address concerns about the potential for the sale to compromise sensitive defence communications. The Treasurer approved the deal subject to conditions designed to protect Australia's security interests and supported by Australian security agencies, including an agreement between SingTel and Defence on access, performance and security matters.³⁵

³² OECD, *OECD Code of Liberalisation of Capital Movements, 2007 Update*. Paris, Organisation for Economic Cooperation and Development, 2007

³³ Australian Treasury, *Summary of Australia's foreign investment policy*,

³⁴ Marchick and Slaughter, *Global FDI policy: Correcting a protectionist drift*,

³⁵ Peter Costello, *Media release by the Former Treasurer Peter Costello No. 060*. Canberra, 22 August 2001.

While China's investment interest in Australia currently focuses on the resources sector, publicly available information about the scale of Beijing's overseas intelligence-gathering activities suggests that any move by a Chinese government-controlled entity to acquire an interest in Australian sectors such as defence or telecommunications which are sensitive in national security terms should receive very close government scrutiny indeed.³⁶

The OECD's investment instruments recognise that investments by government-owned entities can raise concerns as to whether their objectives are commercial or driven by political, defence or foreign policy considerations.³⁷ This risk is also reflected in Australia's guidelines, which recognise that '*investors with links to foreign governments may not operate solely in accordance with normal commercial considerations and may instead pursue broader political or strategic objectives that could be contrary to Australia's national interest.*'³⁸

Some grounds exist for concern about foreign governments using sovereign investment to pursue these non-commercial goals. In a recent statement to the relevant US Congressional subcommittee, Congressmen Manzullo and Marchant stated that '*some SWFs and their governments have challenged US national security interests . . . In particular, the Russian Government's inappropriate use of corporate and capital resources to pursue its international strategic and political objectives . . . should be very alarming.*'³⁹ Less alarming but still of concern – and closer to home for Australia – are reports that the purchase of Costa Rican government bonds by China's State Administration of Foreign Exchange (Safe) was in return for Costa Rica severing ties with Taiwan and establishing relations with Beijing.⁴⁰ This has been cited as evidence of Beijing's willingness to use financial tools for foreign policy ends.

At least theoretically, government-controlled foreign investors could seek to influence the policies and capabilities of recipient countries by taking direct ownership of strategic sectors or critical infrastructure for the purpose of sabotaging it – or using the threat for coercive purposes. They could also seek to exert leverage over government policy through the threat of investment withdrawal or, more subtly, by coopting domestic interests: subtle forms of pressure are more likely than overt threats because of growing economic interdependence.⁴¹ Moreover, sovereign investment does have negative consequences for the international system, including feeding

³⁶ See for example David Cho and Ariana Eunjung Cha, Chinese spying is a threat, panel says. *Washington Post*, 16 November 2007. Also David J Lynch, Law enforcement struggles to combat Chinese spying. *USA Today*, 22 July 2007.

³⁷ Australian Parliamentary Library Paper, *Foreign investment rules and Sovereign Wealth Funds*. Canberra, Australian Parliamentary Library, 2008.

³⁸ See preamble to Attachment A, The Australian Treasury, *Summary of Australia's foreign investment policy*.

³⁹ Donald A. Manzullo and Kenny Marchant, *Statement for the Record Submitted by Congressman Donald A. Manzullo and Congressman Kenny Marchant, 'Sovereign Wealth Funds: New Challenges From A Changing Landscape'*, Committee on Financial Services Subcommittee on Domestic and International Monetary Policy, Trade and Technology, US House of Representatives, . Washington DC, 10 September 2008

⁴⁰ Jamil Anderlini, Beijing uses forex reserves to target Taiwan. *Financial Times*, 11 September 2008.

⁴¹ Brad W Setser, *Sovereign wealth and sovereign power*. Council on Foreign Relations Report No 37. New York, September 2008

growing protectionist sentiment, undermining international financial cooperation and reinforcing authoritarian governments⁴².

It is ultimately impossible to reach clear-cut decisions about the motivations for investment decisions by government-owned entities. As Edwin Truman has pointed out, SWFs 'are governmental entities, and governments are political.'⁴³ Daniel Drezner agrees: 'SWFs are, by definition, extensions of the state. They are therefore viewed as maximising their country's long-term strategic interests rather than as profit-maximising actors.'⁴⁴ It follows that sometimes decisions on whether to oppose such proposals will also be political decisions. And what applies for SWFs will also apply to other forms of government-controlled investment

On balance, we are inclined not to exaggerate either the national security implications of investment in Australia by foreign government-owned entities or the potential for national security concerns to be abused as a means to block legitimate investment proposals, for several reasons:

- we have not been able to find any example of a significant investment proposal that has been rejected by Australia on national security grounds (in the SingTel case the application was approved subject to certain conditions);⁴⁵
- the proportion of SWF foreign investment targeting strategic sectors globally seems relatively insignificant. A June 2008 study by the Monitor Group found that 'The vast majority of SWF investment has avoided sectors in which foreign government ownership may seem threatening to national security in the recipient country'.⁴⁶ They found that investments in transportation, defence, aerospace and high technology comprised less than one per cent of all purchases;
- even where SWFs have made investment decisions based on criteria other than profit maximisation, there seems to be little evidence that any of these attempts to exercise leverage had any policy effects. This is consistent with the international relations consensus that threats of economic exit work only under a limited set of circumstances and theory suggesting that, as a result of economic interdependence, SWFs lack the capability to coerce the OECD economies.⁴⁷

⁴² Daniel Drezner, *Daniel W. Drezner, Professor of International Politics, The Fletcher School, Tufts University, Testimony before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology, Financial Services Committee, US House of Representatives*. Washington DC, September 2008

⁴³ Edwin Truman, *Testimony before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology, Financial Services Committee, US House of Representatives*, . Washington DC, 10 September 2008.

⁴⁴ Drezner, *Daniel W. Drezner, Professor of International Politics, The Fletcher School, Tufts University, Testimony before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology, Financial Services Committee, US House of Representatives*,

⁴⁵ Costello, *Media release by the Former Treasurer Peter Costello No. 060*,

⁴⁶ William Miracky, Davis Dyer, Drosten Fisher, Tony Goldner, Loic Lagarde and Vicente Piedrahita, *Assessing the Risks: The Behaviours of Sovereign Wealth Funds in the Global Economy*, Monitor Group, June 2008.

⁴⁷ Drezner, *Daniel W. Drezner, Professor of International Politics, The Fletcher School, Tufts University, Testimony before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology, Financial Services Committee, US House of Representatives*,

Finally, it should be noted that foreign investment can also have significant *benefits* for national security for the target country as well as the source nation, not least because a commitment to international openness may work as an important contributor to regional or even international stabilisation – with the European Union experience as arguably one of the most successful examples of this process.⁴⁸

The changing global environment

The recent controversy regarding Australia's foreign investment policy regime has to be understood against the backdrop of several developments at the global level.

First, one consequence of the ongoing redistribution of economic power away from both the developed world and from the Atlantic economies is that the developed world is now having to become used to the idea of being a *recipient* of foreign investment from emerging markets in addition to its traditional role of being a source of investment *into* those same countries.⁴⁹

Second, many emerging markets give the state a relatively large role in their economies. As a result, a large share of the new emerging market outward investment is being funnelled through state-owned enterprises, state-owned banks and SWFs. This has posed a dilemma for developed world policymakers. The latter have told their voters that the private sector, not government, should take the lead in managing most businesses. At the same time they have stressed the importance of openness to foreign investment. When confronted by government-controlled foreign investment, one of these propositions has to give. The question is, which one?⁵⁰

This is intensified by a suspicion that government-controlled foreign investors might operate on non-commercial grounds. While defenders of open investment regimes tend to stress that there is no evidence to show malign behaviour by sovereign investors, nevertheless there is evidence that state-controlled investors have motives beyond the commercial, as discussed above.

Third, many developed country governments now face electorates which are increasingly sceptical regarding the benefits of further international economic liberalisation.⁵¹

Finally, the world economy had until relatively recently been experiencing a dramatic resource boom. The resulting surge in commodity prices served to fuel resource insecurity in consuming countries and resource nationalism in producing countries,

⁴⁸ See OECD, Freedom of investment, national security and 'strategic' industries: An interim report, in *International investment perspectives: Freedom of investment in a changing world*. Paris, Organisation for Economic Cooperation and Development, 2007.

⁴⁹ Malcolm Cook and Mark Thirlwell, *The changing global financial environment: Implications for Foreign Investment in Australia and China. Outcomes Report*. Lowy Institute Perspectives. Sydney, Lowy Institute for International Policy, July 2008.

⁵⁰ Mark Thirlwell, Sharing the spoils of China's rise means negotiating some tricky investment twists and turns. *The Australian*, 7 July 2008.

⁵¹ Mark Thirlwell, *Second thoughts on globalisation: Can the developed world cope with the rise of China and India?* Lowy Institute Paper 18. Sydney, Lowy Institute for International Policy, 2007.

simultaneously making the resource sector both an increasingly attractive *and* an increasingly sensitive target for foreign investment.

One consequence of these developments has been an upsurge in ‘investment protectionism’, as scepticism regarding the benefits of FDI has seen a succession of developed economies tighten their foreign investment laws and declare high-profile assets off-limits to foreign investors.⁵²

The intensification of the international financial crisis following the bankruptcy of Lehman Brothers on 15 September 2008 has altered this global environment for foreign investment in at least four important ways.

First, the deepening financial crisis has produced a sharp fall in asset prices and a rise in risk aversion across the world. In the short term, this looks set to reduce the availability of foreign capital. Projections for FDI next year are now being slashed. The OECD thinks that global FDI inflows will be down 13% by the end of 2008, and continue to fall into 2009.⁵³ More competition for scarce foreign investment could encourage governments to be more mindful of discouraging foreign investors through regulatory changes. At the same time, however, lower asset prices might encourage bargain hunters which may trigger fears about so-called ‘fire sale FDI’.

Second, the downturn in global economic and financial conditions has brought an abrupt end to the resources boom. As a result, resource scarcity/nationalism issues may fade somewhat in importance.

Third, the outlook for growth across the world economy has deteriorated markedly and there is some danger that tougher economic times will intensify existing protectionist pressures.

Finally, the crisis has seen a dramatic expansion in the role of the state in developed country financial systems. Given these changes, developed country claims regarding their desire to limit the role of government in their economies will now ring somewhat hollow.

The Australia-China bilateral relationship

While shifting global conditions have certainly played a role in influencing the foreign investment climate within Australia, however, the current policy challenge is located very precisely in the context of the bilateral Australia-China relationship, and

⁵² According to the executive director of Columbia University’s international investment program, for example, there are clear signs of a re-evaluation of the benefits of FDI; usually around 90% of the new laws governing FDI passed around the world each year make it easier for foreigners to invest, while in the last three years, 30-40% of laws have moved in the direction of making foreign investment less welcome. Alan

⁵³ The OECD points to two factors likely to depress FDI in the months ahead: the locking up of credit markets combined with sharp falls in equity markets have forced firms to rely largely on cash reserves to fund their investment, and the soft outlook for global growth has reduced considerably the need for companies to invest in new capacity. OECD, Grim outlook for FDI and shifting global investment patterns, in *Investment News*, November 2008, Issue 8. Paris, Organisation for Economic Cooperation and Development, 2008.

in particular in the surge of *Chinese* investment into the Australian resource sector, and in Canberra's response to that surge.

To some extent, the rise in Chinese interest in investing in Australia should come as no great surprise.⁵⁴ Until recently, the bilateral economic relationship has been a very lopsided one. Trade ties have been deep, and getting deeper: in 2007/8, two-way trade in goods and services reached A\$63.7 billion, accounting for 13% of total Australian trade and making China our largest trading partner. In marked contrast, investment links have been very modest. The total stock of Chinese foreign investment in Australia at the end of 2007 was a mere \$6.2 billion, or less than half of one percent of the value of total foreign investment.

That large gap between the scale of the trading and investment relationships has now started to close. Moreover, it has been showing signs of doing so very quickly. Over the past two financial years, Australia has approved some A\$10 billion in proposed Chinese investment, and earlier this year forecasts for 2007-08 suggested a figure for proposed investment in excess of A\$30 billion.⁵⁵ In this sense the China relationship is following the pattern of Australia's highly successful economic relationship with Japan, dating back to the 1970s, which saw major Japanese investment follow trade in the resources sector. Not surprisingly, such a dramatic increase has caught the attention of policymakers, as have high profile deals such as Chinalco's US\$14 billion dawn raid on Rio Tinto.

One important complication with regard to Chinese investment arises from the nature of the Chinese economic model. Since Australia's Foreign Investment Policy requires that every investment proposal from a government-controlled entity undergo inspection by the FIRB, and as a great many Chinese businesses have government-ownership stakes, a large share of Chinese investment in Australia inevitably falls into the review process.

A further important complication is (geo-) political. Traditionally Australia's most important trading partners have also been our key security partner (the UK and then the US) – or at least an ally of our key security partner (Japan), all of them democracies. Now for the first time our largest trading partner is authoritarian, a quasi-mercantilist, and a strategic competitor of our major ally.

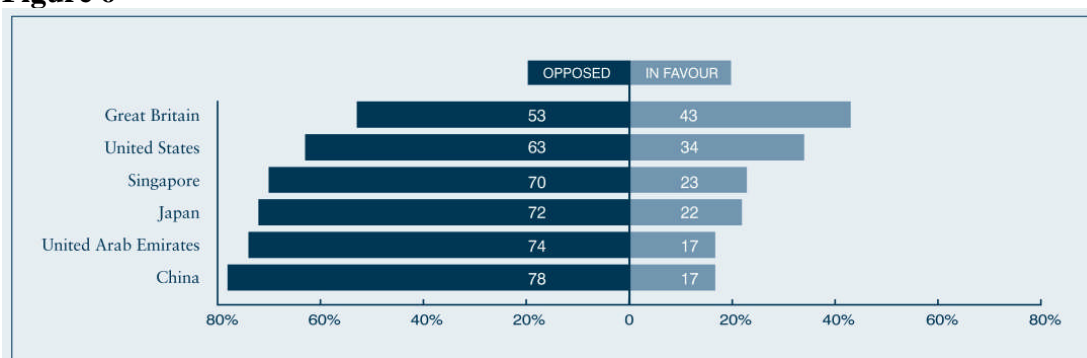
Public opinion seems to be alert to these emerging complexities. *The Lowy Institute Poll 2008* showed that 62 per cent of Australians agree that China's growth has been good for Australia but also revealed growing unease about the strategic consequences of China's rise: 60 per cent agreed that China's aim is to dominate Asia and 52 per cent agreed that Australia should join with other countries to limit China's influence.

⁵⁴ Thirlwell, Sharing the spoils of China's rise means negotiating some tricky investment twists and turns.

⁵⁵ Swan. *Australia, China and this Asian Century*. Speech to the conference "The changing global financial environment: Foreign investment in Australia and China", an Australia China Business Council Forum in collaboration with The Lowy Institute for International Policy and the Faculty of Business and Economics, Monash University.

China was the most opposed in a list of potential sources of foreign government-controlled investment (Figure 6).⁵⁶

Figure 6



Source: Hanson, *Australia and the World: Public Opinion and Foreign Policy. The Lowy Institute Poll 2008*. (2008)

Should we worry specifically about the resource sector?

Importantly, the current policy challenge relates not just to Chinese investment, but more specifically to Chinese investment in the *resources* sector. A particular issue that arises here relates to presence of resource rent – that is, the supernormal or excess profit that is earned in the exploration, development and extraction of mineral deposits. Resource rents can be a product of the quality differential between mining projects: Australia is a low cost iron ore producer, for example, and so at a world price that is set by the (higher cost) marginal producer earns a rent that cannot be competed away.⁵⁷

In the case of the iron ore market – which has a market structure that looks something like a cartel with a fringe of smaller players, whereby a small number of large players set the price taking into account the impact this will have on the fringe producers – it should be possible for the major producers to restrict output in the face of strong, inelastic demand to extract an additional scarcity rent.⁵⁸ Crucially, using market power to restrict output and drive up scarcity rents may be in the national interest of

⁵⁶The question asked with regard to foreign investment was: ‘If a company, bank or investment fund controlled by a foreign government was trying to buy a controlling stake in a major Australian company, please say whether you would be strongly in favour, in favour, opposed, strongly opposed or you don’t know, if the foreign government was the government of:’ Hanson

⁵⁷The definition of resource rent is from Lindsay Hogan, *International minerals taxation: Experience and issues*. ABARE conference paper 08.11. Canberra, Australian Bureau of Agricultural and Resource Economics, 2008.

⁵⁸This argument is developed in Adrian Blundell-Wignall and Gert Wehinger, *Open capital markets and sovereign wealth funds, pension funds and state-owned enterprises*. Paper presented at the conference "Sovereign Wealth Funds in an Evolving Global Financial System" held at the Lowy Institute on 25-26 September 2008 and organised by the Lowy Institute and the Centre for Applied Macroeconomic Analysis in the Australian National University College of Business and Economics. Sydney, 2008. In their paper the authors are at pains to note that there are very few circumstances, where foreign investment policy should be used to restrict investment in the resource sector, but note that the national interest issues raised by the discussion of resource rents merits further study.

the producing country, since this might allow it to take advantage of the Hotelling condition.⁵⁹

It follows that allowing a foreign investor from a consuming country like China to make an investment that will compromise the use of that market power may not be in Australia's national interest, since China and Australia may well have divergent interests when deciding on pricing and on how the economic and scarcity rent is to be shared. If the investor is government-controlled, these conflicting national interests are arguably even more likely to come to the fore: with its rapidly growing demand for resources, China, for example, might prefer that output expand at a more rapid rate (and lower price) than may be in Australia's national interest.⁶⁰

Don't Panic

There is no need to panic about Chinese foreign investment into Australia and the consequences for the national interest, however. In particular, there is no need to tighten Australia's existing foreign investment framework.

At present, the majority of foreign investment into Australia is – quite rightly – not treated by the existing policy framework as threatening our national interest in any way, whether by virtue of its size or the particular sector into which it is headed. For the same reasons, this will remain the case even as the flow of Chinese investment increases. In other circumstances where there are particular concerns – related to competition or government revenues – there are other domestic policy tools (competition policy, taxation policy) that can be brought to bear without turning to additional restrictions on foreign investment.

That will still leave some sectors and investments that will trigger sensitivities, regardless of whether the foreign investor is government or privately controlled. Here, the existing policy framework already provides the Treasurer with plenty of scope to intervene. Indeed, since the veto of Shell's attempted takeover of Woodside in 2001 a common criticism has been that that there is too *much* discretion available, not too little.

There will also be a small number of cases where Canberra will decide that while a private sector investor is acceptable, a government-controlled one isn't. We suggested above that one example of this situation could arise in the case of a foreign government-controlled investor taking a significant stake in a resource company that can exercise market power. The Government is already thinking along these lines: according to the Treasurer, *'as the proposed participation by a consumer of the resource increases to the point of control over pricing and production, and especially where the resource in question is already developed and forms a major part of the total resource, or where the market disciplines applying to public companies are*

⁵⁹ The Hotelling condition states that a country should run down its exhaustible resource in such a way that the net price rises at the rate of interest.

⁶⁰ Note that if the target of Chinese investment does not have any global pricing power, then no such issue arises. Alternatively, if the foreign investor is a private resource extraction company, then again no issues should arise, since the company is likely to use its market power to maximise the price for shareholders. Blundell-Wignall and Wehinger, *Open capital markets and sovereign wealth funds, pension funds and state-owned enterprises*,

*absent, I will look more carefully at whether the proposal is in the national interest.*⁶¹ Again, the current framework, even prior to the announcement of the six principles on 17 February 2008, already provides adequately for such circumstances in the form of the national interest test, allowing the Treasurer to either set appropriate conditions to mitigate specific concerns, or to exercise an outright veto.

Overall then, fears that the current foreign investment framework is inadequate to deal with the challenges posed by Chinese investment are unfounded. At the same time, however, concerns about the adverse consequences of the existing foreign investment regime should not be exaggerated. Granted, the additional elaboration provided by the Treasurer's enunciation of six guidelines for foreign investment was probably unnecessary, in that the existing national interest test was already quite adequate.⁶² But some of the concerns now being expressed about the political nature of the process either look overdone or ignore political realities.

This is not to say that we think there is no room for improvement. The FIRB process in particular is often criticised for a lack of transparency, and it is possible that some improvements could be made here. That said, it appears that one major constraint is the requirement of the companies themselves to secure commercially confidential information. Moreover, when the Treasurer did move to increase the transparency of the process by announcing his six principles, this was instead seen in some quarters as adding additional restrictions to the investment process.

One change that we think is worth considering is extending the terms offered to the United States under the AUSFTA to all foreign investors. This would remove the current bias in the foreign investment process and at a minimum provide a reduction in transaction costs, along with at least the potential for some significantly larger welfare gains, while leaving the national interest test intact. A complicating factor here, however, at least regarding timing, is Australia's continuing bilateral FTA negotiations with China, Japan and several other economies, since Canberra may see some bargaining advantage in holding back investment concessions until these have been concluded.

⁶¹ Swan. *Australia, China and this Asian Century*. Speech to the conference "The changing global financial environment: Foreign investment in Australia and China", an Australia China Business Council Forum in collaboration with The Lowy Institute for International Policy and the Faculty of Business and Economics, Monash University.

⁶² This is also the conclusion reached by Drysdale and Findlay, *Chinese foreign direct investment in Australia: Policy issues for the resource sector*,

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2007 stock of inward FDI as % of GDP

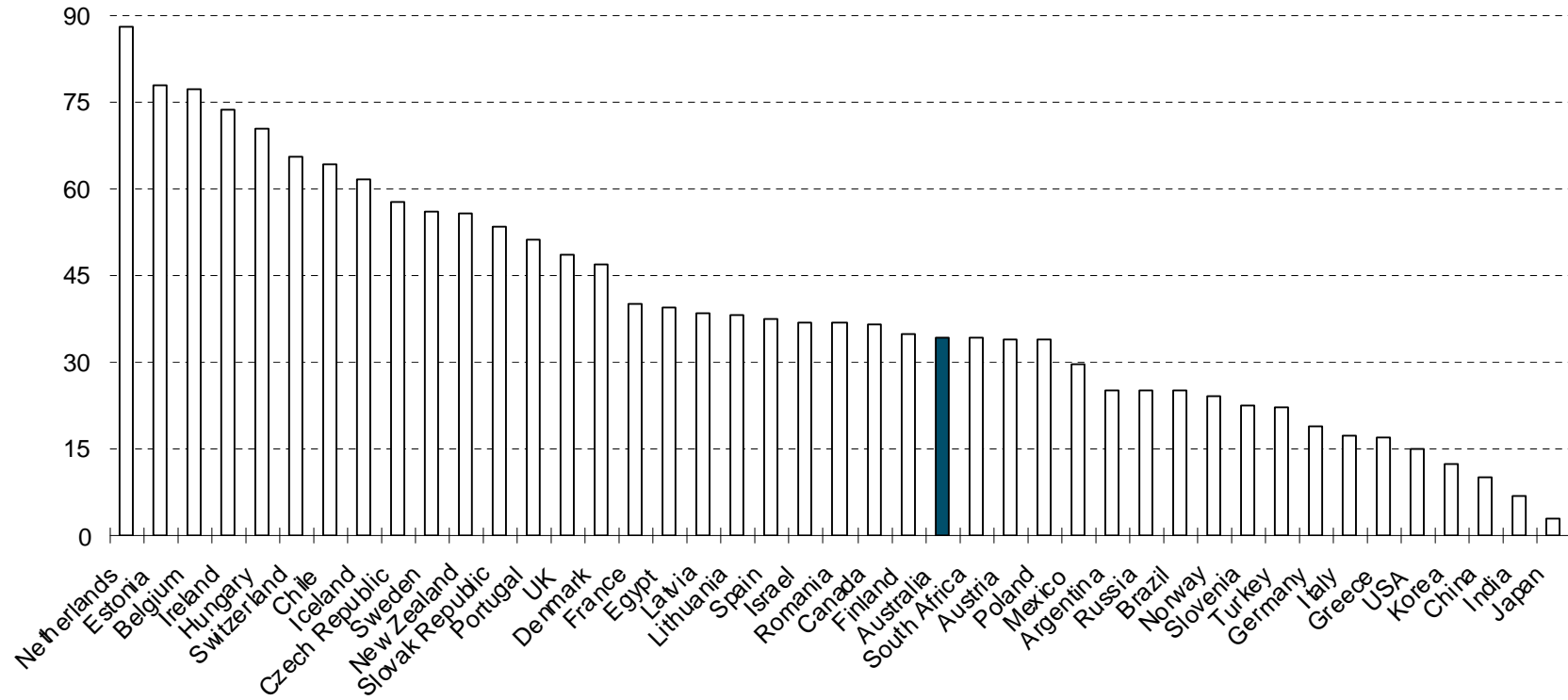


Figure 1

A T Kearney 2007 FDI Confidence Index

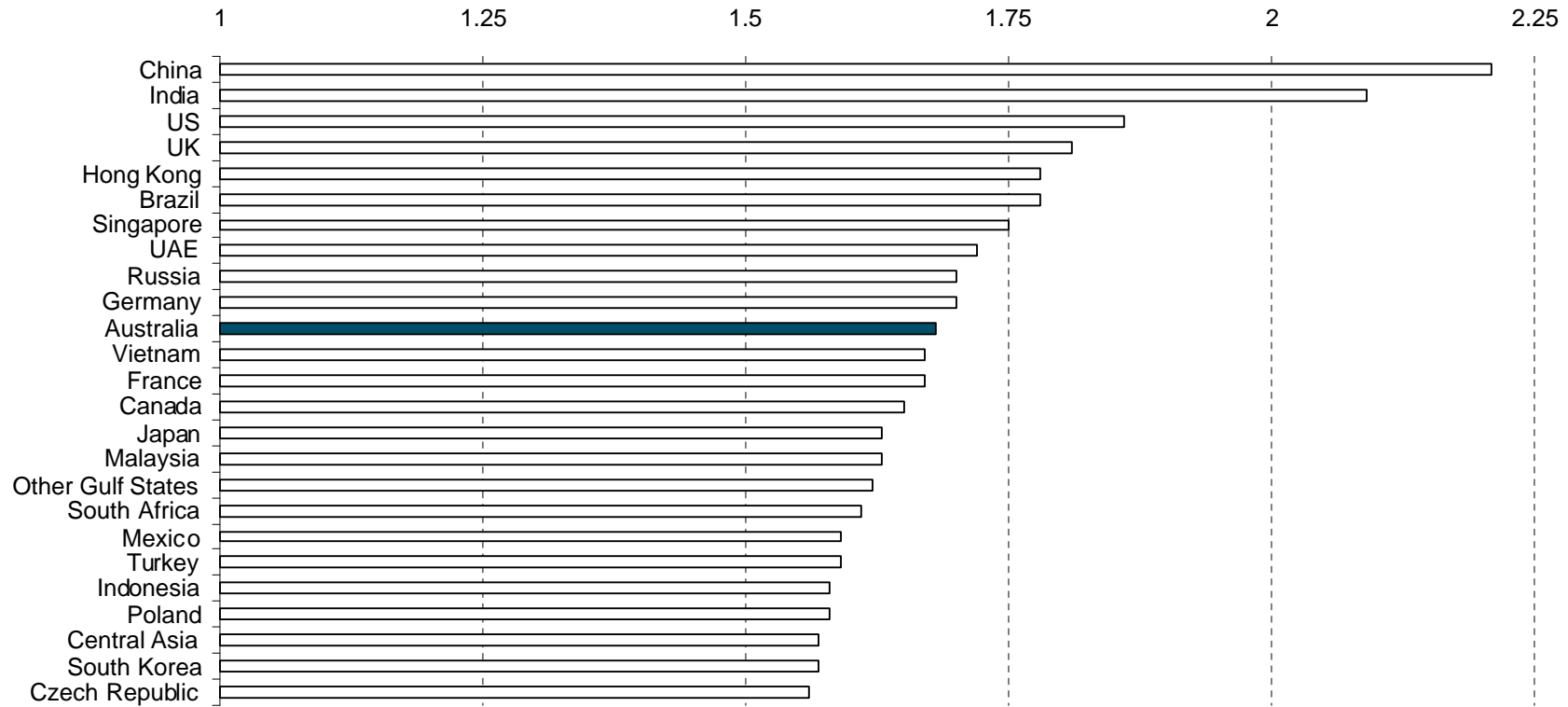


Figure 2

Heritage Investment Freedom Sub-index

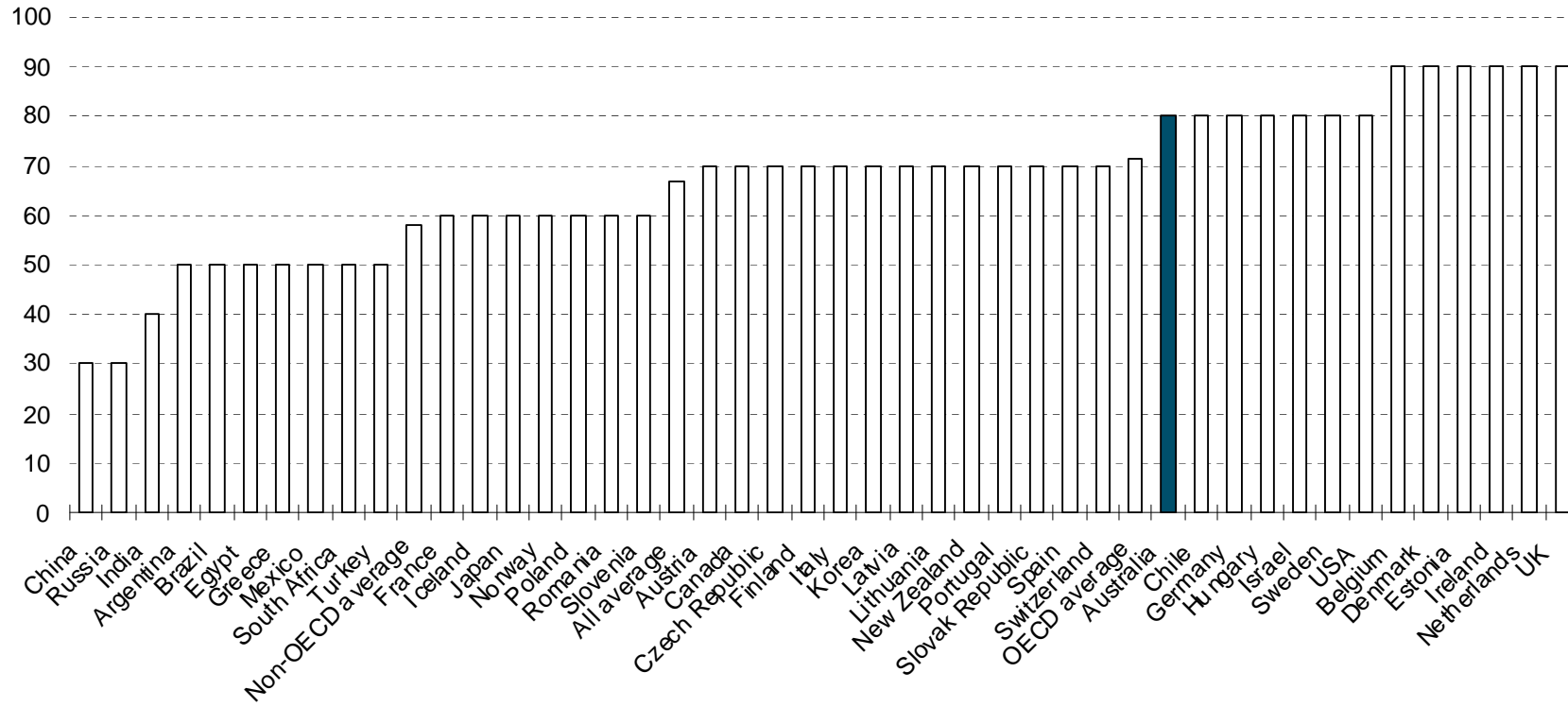


Figure 3

OECD FDI restrictiveness index

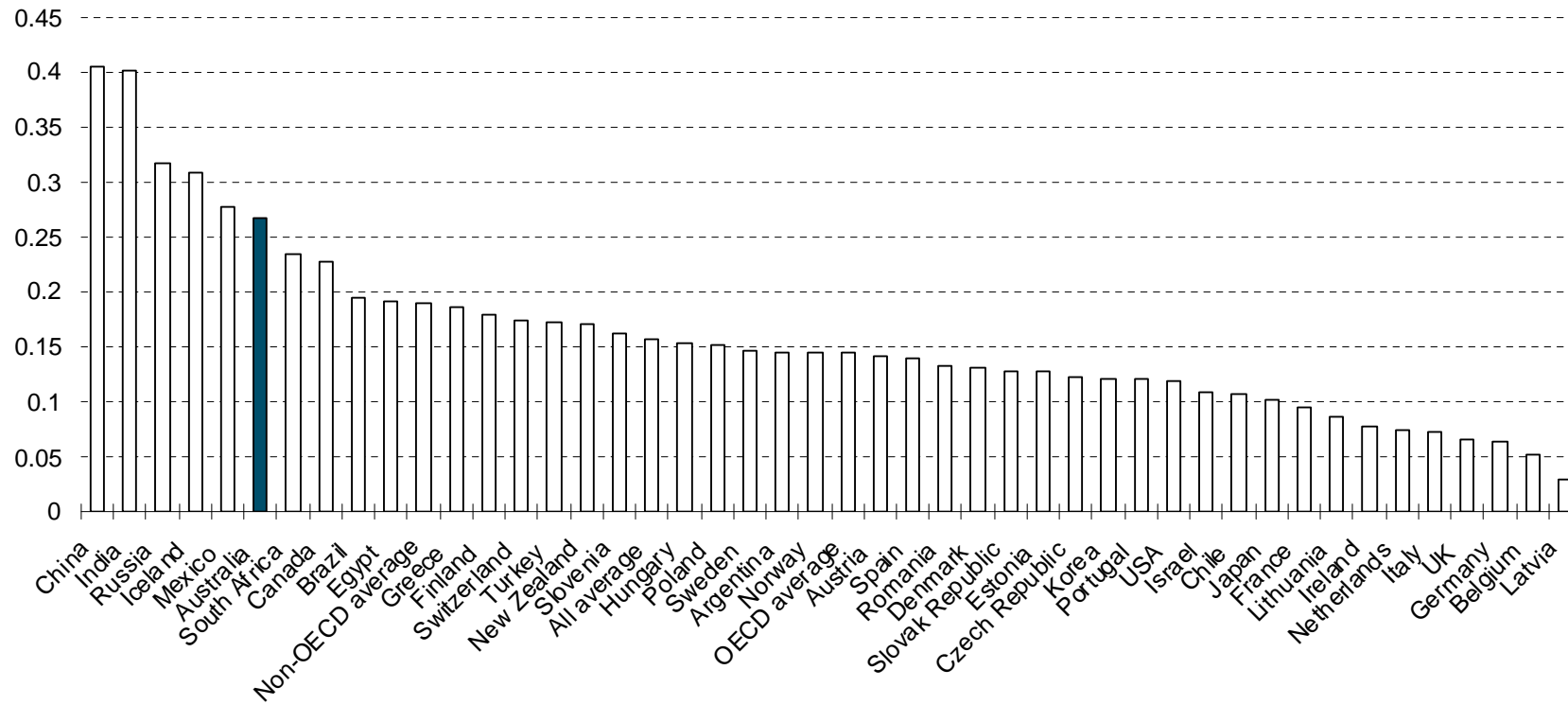


Figure 4