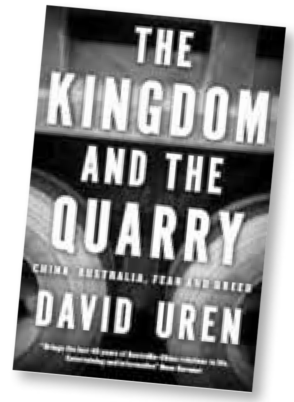
THE KINGDOM AND THE QUARRY: CHINA, AUSTRALIA, FEAR AND GREED

Adopting a more mercantilist attitude to our commercial relations with China would be poor policy, argues **Stephen Kirchner**



By David Uren
Black Inc, Melbourne, 2012
$29.99, 260 pages
ISBN 9781863955669

The Kingdom and the Quarry examines the increasingly important economic, diplomatic and security relationship between Australia and China. Although the narrative begins in 1976, the focus is on the period since the accession of Kevin Rudd as prime minister of Australia in 2007.

David Uren's book is particularly strong on the politics of Chinese foreign direct investment (FDI) in Australia. The surge in FDI from China following Rudd's election exposed the weakness and inappropriateness of Australia's Whitlam-era regulatory regime for FDI. The *Foreign Acquisitions and Takeovers Act* gives the federal treasurer enormous discretion to reject foreign acquisitions deemed not in the 'national interest.' The national interest is deliberately left uncodified in the legislation to ensure the treasurer's decisions are outside the scope of judicial review.

Successive Australian governments have nonetheless sought to articulate a foreign investment policy through a Treasury document that has become an ever-growing laundry list of considerations that might be taken into account when applying the 'national interest' test. But these considerations and the advice of the Foreign Investment Review Board are not binding on the treasurer. If anything, they serve to expand rather than circumscribe the scope of the treasurer's discretion.

This discretion is a standing invitation for political intervention in the market for the ownership and control of Australian equity capital and for politicians to second-guess what should be commercial decisions. This politicisation of FDI came dramatically to the fore with Chinalco's bid for an increased stake in Rio Tinto in 2008. As Uren notes, 'the fact that Australia's foreign investment regulation included both legislation with requirements carefully spelt out, and government policy, which is barely written down and carries no formal sanction but must nevertheless be obeyed, was difficult for Chinese investors to grasp' (p. 77). Chinese investors were hardly alone in this regard. The Rudd government was unable to articulate a coherent policy. This became a significant source of tension, made worse by Rudd's view that the Chinalco bid had shown insufficient deference to his government.

The domestic political concerns raised by the acquisition revealed more about the mercantilist and central planning mindset of Australian politicians than of the Chinese. Rudd took the acquisition to the National Security Committee of Cabinet and commissioned an inter departmental discussion paper on the transaction. The result was the issuance of yet more guidelines.

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Rudd was 'taking a keen interest and getting involved in matters of fine detail.'

> A number of proposals got caught in a holding pattern as the paperwork sat in the prime minister's office … Sometimes Rudd would get cross and demand to know what was the hold-up, leaving staffers to explain that he was part of the problem' (p. 82).

Although it would be easy to dismiss this as symptomatic of Rudd's notoriously dysfunctional approach to public administration, this level of political interference in a commercial transaction was only possible because of Australia's regulatory regime for FDI.

The treatment Chinalco received at the hands of the Australian government was appalling even to the Chinese, who were used to dealing with their own authoritarian regime. The head of Chinalco's international operations was eventually summoned to the treasurer's Brisbane office for a meeting with Rudd, 'who had three messages for the Chinese company.'

> First, its 9 per cent investment in Rio Tinto would be approved by the FIRB. Second, if it thought it had a bigger deal coming, it was dreaming. Third, if anyone ever found out that this meeting was being held, Chinalco would never do anything in Australia again' (p. 84).

It is ironic that Australia should address concerns about the role of foreign governments in FDI by becoming even more like those governments in its behaviour.

The Labor government's mercantilist and central planning mindset is found in equal measure on the other side of politics. Former Treasurer Peter Costello opposed the Chinalco acquisition, arguing that Australia needed 'national champions … flag carriers' (p. 98). As Treasurer, Costello had rejected Shell's proposed acquisition of Woodside Petroleum in 2001 for barely disguised political reasons. He hobbled the efforts of Australian companies to expand abroad by placing conditions on BHP's dual-listed company structure that had the explicitly protectionist rationale of keeping head office jobs in Australia. In opposing the Chinalco deal, then opposition leader Malcolm Turnbull even invoked Chairman Mao's nationalist rhetoric, saying, 'If we wish to express our approach in Chinese, then we could paraphrase Mao Zedong and say *Aodalia renmin zhan qilai le*—the Australian people have stood up' (p. 98). Turnbull's concerns about foreign state-owned enterprises do not sit easily with his support for an Australian sovereign wealth fund.

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The domestic political reaction to the Chinalco bid for Rio showed that most Australian politicians and many commentators have little understanding of how international commodity markets function and how export prices are determined. They imagine market power where there is none. As Uren puts it, Australian politicians were jumping at shadows. The Australian Competition and Consumer Commission saw no competition policy concerns with the Chinalco bid, while the Australian Taxation Office is well equipped to address any transfer pricing issues. If foreign investment were regulated on a non-discriminatory national treatment basis, that would have been the end of the Australian government's involvement.

The view that Chinalco was an agent for the Chinese state seeking control over Australian resources is easily refuted. China's National Development and Reform Commission (NDRC), which approves China's outward FDI, was unenthusiastic about this and other foreign acquisitions (p. 80). When the deal fell through, Chinalco was hung out to dry by the Chinese government. Chinalco had used a convertible note issue, not to circumvent the FIRB but to ensure it ranked ahead of other creditors in the event Rio collapsed (p. 93). The Stern Hu affair showed how the realities of the international marketplace consistently frustrated the attempts of Chinese central planners to control the prices their steel mills paid for iron ore.

The Rudd government began rejecting or imposing conditions on other Chinese acquisitions. These conditions were remarkable mainly for their inconsistency and over-reach. Sinosteel's bid for Murchison Metals was capped at 49.9% over concerns about vertical integration. This was were inconsistent with decisions taken in relation to the foreign (but not Chinese)-owned aluminium industry, where the Australian government is 'complicit in denying transparency in the market for intermediate product' (p. 81).

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Minmetals' acquisition of OZ Minerals was rejected on national security grounds because of assets in the Woomera Prohibited Zone, despite previously having cleared the proposal with the Department of Defence, which then inexplicably changed its tune. It is hard to imagine a less efficient way for the Chinese to engage in international espionage. The subsequent conditional approval of Minmetals' acquisition of OZ Minerals' assets marked a new era in FDI protectionism. The treasurer's press release stated that the conditions and undertakings required of Minmetals 'are designed to protect around 2000 Australian jobs.' Some of these conditions, such as the requirement to 'comply with Australian industrial relations law and honour employee entitlements' are the legal obligations of any company operating in Australia, regardless of ownership, and are therefore redundant. The reporting requirements imposed on the company were also already required under the *Corporations Act*. Yet there were also some extraordinarily prescriptive conditions in relation to corporate governance and operational matters, including levels of output and employment. The regulation of FDI had effectively become an arm of Australian domestic industry and employment policy. The Rudd government was sending increasingly strong signals to prospective foreign investors telling them to conduct their business operations in Australia according to politically determined requirements and objectives.

Treasurer Wayne Swan rejected a bid by China Nonferrous Metals Company to buy 51.7% of Lynas Corp, against the advice of the FIRB, after reading an article in the *New York Times* about rare earths and China's supposed attempt to corner the international market for the same (p. 103). Apart from displaying Swan's intellectual weakness, this episode shows that the FIRB is not independent of government and its advice can be ignored. The FIRB's role is to provide a fig leaf of bureaucratic respectability for ministerial discretion.

The FIRB has been justly criticised for a lack of transparency and accountability. Uren mentions this reviewer's involvement in the issue when he notes that I 'tracked down a transcript of [an elusive speech by FIRB Executive Director Patrick Colmer] and posted it' on my web site (p. 105). This is something of an understatement for what was a protracted Freedom of Information request on my part designed to embarrass the FIRB over its lack of transparency. Uren could have made much more of this episode, but at least he made the essential point that the FIRB is part of the problem in the regulation of FDI.

Uren concludes that whereas China has learned important lessons in its dealings with Australia in recent years, 'there has been no similar reflection in Australia' (p. 110). Uren is one of the few journalists to understand that the *Foreign Acquisitions and Takeovers Act 1975* (FATA) and the FIRB add nothing to the regulation of business investment in Australia that is not already provided for by the robust and internationally respected domestic regulatory regime that already applies regardless of ownership. The FATA, the government's notional foreign investment policy, and the FIRB serve only the interest of politicians in interfering with commercial transactions they don't like, for reasons they can scarcely articulate, and in ways that make us more like the foreign governments they worry about. Uren doesn't say so, but some Australian academic economists have been complicit in this regime, arguing that the FATA and the FIRB help defuse populist sentiment in favour of a more restrictive regime. Yet it should be clear by now that the existing regime serves to normalise rather than contain political interference. It is a regime that is also an aberration in terms of Australia's historical experience, an inward turn from the open-door policy that prevailed in Australia until 1969.

Uren also explores the diplomatic and security relationship and the potential for tension between Australia's growing relationship with China and its traditional security alliance with the United States. There is a view promoted by strategic analysts like Hugh White that Australia may be compelled to choose between China and the United States—this camp seems to lean towards erring on the side of China. It is a view China itself readily promotes in its efforts to separate the United States from its alliance relationships in Asia. Yet it is also a view rejected by most other countries in the Asia-Pacific region, who have responded to China's rise by developing even closer relations with the United States.

For his part, Uren argues:

> If the United States-China relationship becomes contested, Australia cannot satisfy both powers. More thought has gone into securing the alliance with the United States that into reassuring China of Australia's reliability. Very little has gone into the question of how Australia would manage rivalry between the two states. (p. 225)

Yet there is probably very little that Australia could do to prevent or mitigate the consequences of a severe deterioration in the China-US relationship, especially if that leads to military conflict. Such a conflict would be a disaster for all concerned, and the damage to Australia's interests would be severe regardless of how Australia aligns or does not align itself.

Australia is arguably a 'price-taker' in a strategic as well as an economic sense. It was symptomatic of Rudd's vanity and hubris that he thought he could personally reshape the diplomatic and security architecture of the Asia-Pacific region. But Rudd did at least recognise that Australia's security interests were best served through our relationship with the United States. Protagonists on the pro-US side of the debate like Greg Sheridan have also been suspicious of Chinese FDI, but there is no necessary inconsistency in being a security hawk and an economic liberal when dealing with China. The idea that Australia will have to choose between its relationship with China and the United States is based on an exaggerated view of our ability to shape much larger forces. My former CIS colleague John Lee is probably right in arguing for the intellectually modest view that 'constructing an infallible strategic and economic approach [to China and the United States] is inherently impossible. We can only respond incrementally to the evidence as it unfolds.'*

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The Rudd government's 2009 defence white paper was notable for its more or less explicit focus on China and its ambitious defence capital equipment shopping list for the Australian military. But as with much of Rudd's policy agenda, this project now lies in tatters, with defence spending as a share of GDP at its lowest since 1938. Uren says 'one of the scenarios that Australia needs to consider is that Obama and his successors cannot deliver on the promised "pivot" to Asia,' leaving Australia's security more exposed to China (p. 228). This

* John Lee, 'Divergence in Australia's Economic and Security Interests?' in James Reilly and Jingdong Yuan (eds.), *Australia and China at 40* (Sydney: UNSW Press, 2012).

is more reality than scenario. The US 'pivot to Asia' is a thinly disguised attempt at managing US global military decline made worse by bad economic policy at home. The United States has gutted its defence budget and capabilities along with Australia. If China is a growing strategic threat, it is partly because the United States and Australian governments have allowed other priorities to divert attention and expenditure away from one of the most basic and legitimate functions of government. Those who profess concern about the security implications of China's rise would do well to argue for expenditure reform at home.

Although China's leadership undoubtedly has mercantilist instincts that are reflected in policy, these instincts are more likely to change with the further integration of China into the world economy.

Classical liberals believe, perhaps optimistically, that closer economic engagement makes conflict less likely. It is surely no accident that China-US and China-Australia relations were far more conflicted, not least militarily, in the 1950s and 1960s when China was a closed economy, even though the diplomatic thaw of the early 1970s came before the opening up of China's economy. Japan's expansionist policies of the 1930s were motivated by a mercantilist view of the world that was also reflected in the West and associated with a collapse in world trade that compounded the Great Depression. World War II soon followed.

Although China's leadership undoubtedly has mercantilist instincts that are reflected in policy, these instincts are more likely to change with the further integration of China into the world economy. As already noted, exposure to the realities of international markets is the best cure for mercantilist fallacies. Australia could further that process by repealing the FATA (*Foreign Acquisitions and Takeovers Act*) and abolishing the FIRB. Then opposition leader John Howard proposed abolishing the FIRB in his 'Future Directions' policy manifesto in 1988. A prospective Australia-China Free Trade Agreement could also be used to establish a more open-door investment regime for China similar to that now made available to the United States under the Australia-US Free Trade Agreement. The worst thing Australia and the United States could do is to embrace mercantilist doctrines and policies, effectively validating the world view of those in China who think in similar terms.