A Long March: The Australia-China Investment Relationship

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Executive summary

Both the Australian Government and Opposition stress that they welcome Chinese investment in Australia and appreciate the benefits such investment brings. At first glance, this official welcome seems to be working. Australia has been the top destination for China's offshore investments, especially into the resources sector. But Australia's ranking is slipping.

That reflects a range of factors, many of them outside our direct control, including an understandable desire by China to diversify, by sector and by country. Other factors, including new taxes, labour costs and the quality of infrastructure are within our control, but not specific to the bilateral relationship. However, that still leaves some important factors that are both within our control and specific to the Australia-China relationship. In particular, Chinese investors do not feel as welcome in Australia compared to other countries competing for Chinese investment. There are perceptions of a lack of trust and even discrimination, often linked to the additional Australian government scrutiny accorded Chinese government-related investments.

Australia should be concerned by these perceptions of mistrust and investment discrimination by our largest trading partner. Several steps could be taken to improve the bilateral investment relationship, including better communication and engagement, regulatory changes, enhanced cooperation in two key investment sectors, and a swift and pragmatic conclusion to the negotiations for an Australia-China Free Trade Agreement (FTA).

Introduction

In many ways, the foundations of the Australia-China economic relationship appear very strong. China is Australia's most important trading partner. Australia is the top destination for Chinese Offshore Foreign Direct Investment (OFDI). China is Australia's top source for services exports (mainly education and tourism). China's growth has created Australia's biggest trade opportunity, as well as a new source of capital.

Despite all of this good economic news, the bilateral relationship is subject to strains. Some of these relate to political or strategic issues. But even within the economic relationship there are problems; in particular, Chinese perceptions of Australian discrimination against their efforts to invest in this country. These tensions in the investment relationship, combined with broader difficulties in the relationship, make China Australia's greatest diplomatic challenge.

This paper examines Chinese perceptions of Australia as an investment destination. It updates an earlier paper on the same subject that found that Chinese investors, some of their advisers and Chinese government officials felt that Australia discriminated against Chinese investment, and explored the reasons for that perception.[1] As with the previous paper, this paper draws on confidential interviews with Chinese and Australian investors, their advisers and government officials from both countries.[2]

This paper concludes that 'trust' is often at the heart of the investment issues between the two countries and, indeed, between China and many other countries. This, of course, reflects the fundamental differences in China's political, institutional, economic and social structures, as well as history, compared with other countries. Related to that, is the leading role of Chinese State Owned Enterprises (SOEs) in China's economy and China's OFDI. This paper explores these issues and puts forward some steps that both countries could take to improve the bilateral investment relationship, reduce the risk of misunderstanding and lower the risk of contaminating the broader Australia-China relationship.

Trends in Chinese OFDI flows

From around 2007 China's OFDI rose rapidly from a standing start. China became a major new global capital source, although growth eased in 2011. Even with rapid growth, China's OFDI is substantially below some other countries, particularly the United States (Chart 1).[3]

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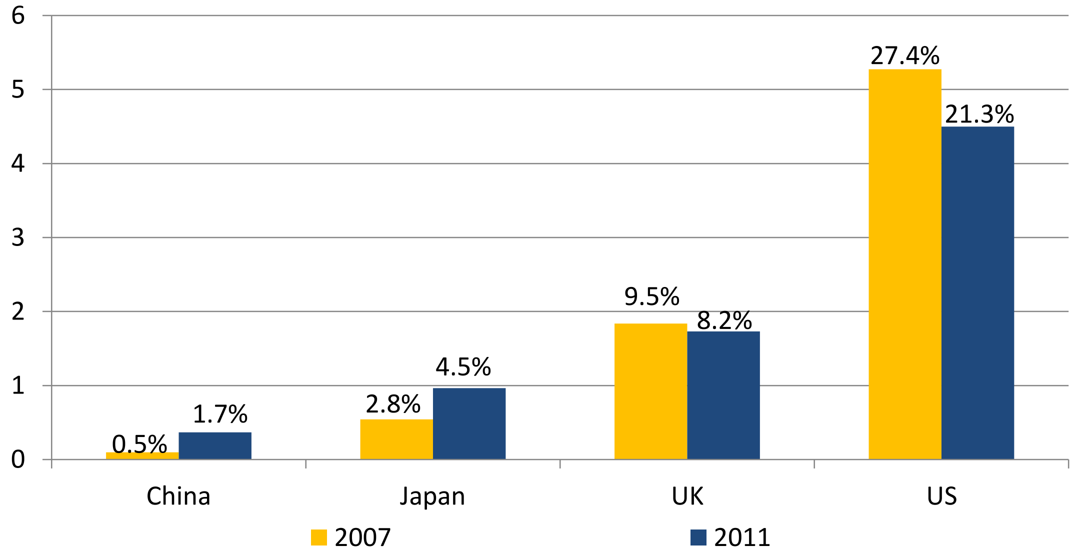
[1] John Larum, *Chinese perspectives on investing in Australia*, Lowy Institute Analysis, June 2011.

[2] The authors spoke with around 50 different contacts in Beijing and Sydney from March to August 2012. This included the relevant Chinese government authorities and ministries that oversee Chinese OFDI. Investment advisers, as a group, were the most important source for gauging Chinese investors' perceptions and experiences.

[3] While China's OFDI stock was only 1.7% of the global total in 2011, this followed a number of years when China's OFDI flows represented 4 to 5% of global OFDI flows. Source: UNCTADstat.

Chart 1: Total Offshore Foreign Direct Investment (OFDI)
USD trillion, % of global total

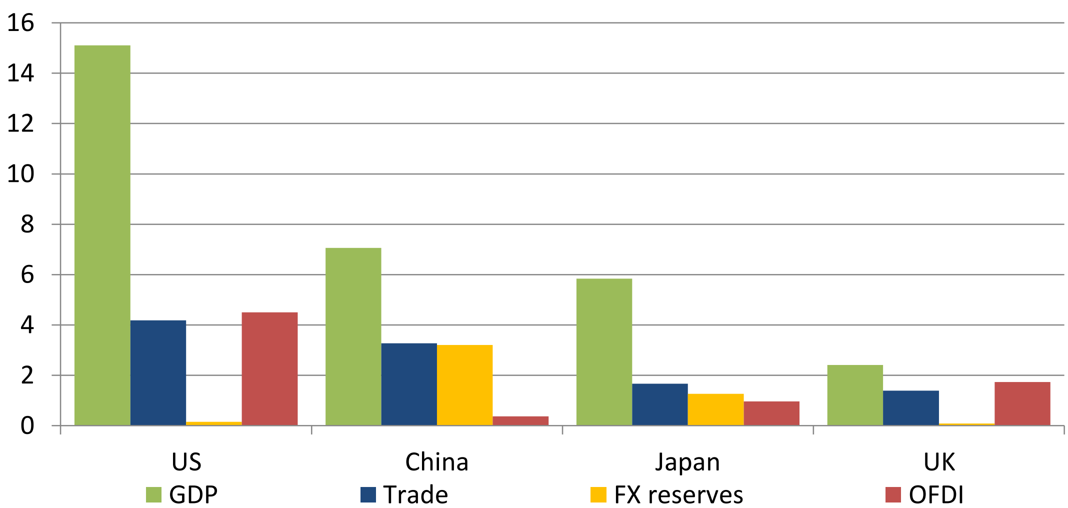


Source: United Nations Conference on Trade and Development (UNCTAD), UNCTADstat database

China's rapid OFDI development has been the result of a 'go global' policy initiated by President Jiang Zeming in 1992 and included in the 10th five year plan in 2001. However, substantial outflows did not start until 2007, when the global financial crisis (GFC) provided significant new investment opportunities. Underlying the 'go global' strategy was a range of objectives, including greater resource security and the diversification of China's external assets. Chinese companies have also sought offshore growth opportunities to build international brands, acquire technology and improve operational efficiency, quality and management skills.

China has substantial capacity to increase its OFDI further. This reflects several factors. First, China's current level of OFDI is below that which might be expected given the size of its overall global economic footprint (as represented by GDP, trade and foreign exchange (FX) reserves) (Chart 2).

Chart 2: International economic indicators
USD trillion

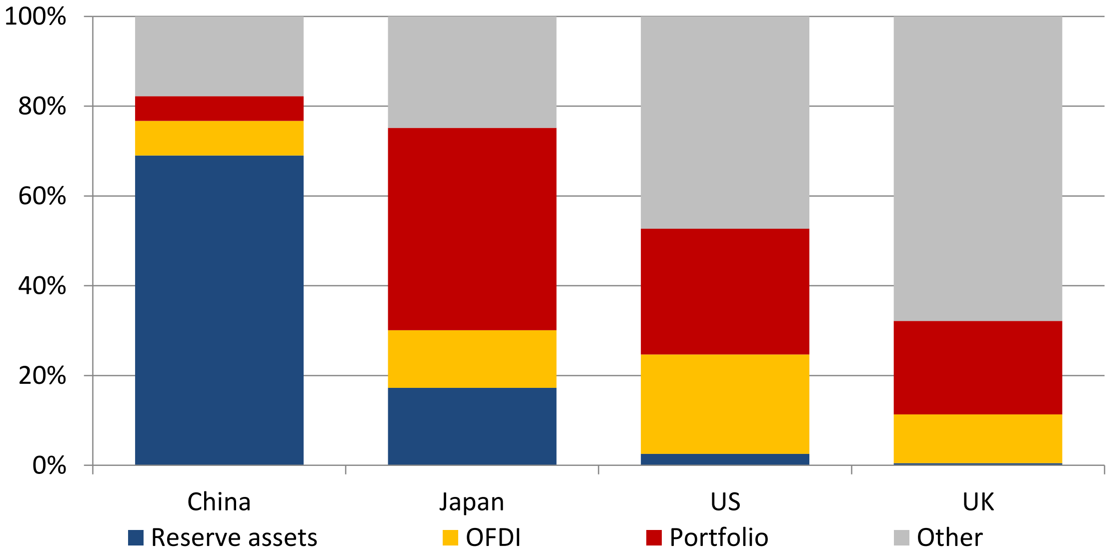


Source: UNCTADstat database

Second, China has a large stock of external assets, which are not well diversified. China's external assets are concentrated in reserve assets, most of which are FX reserves invested in low-yielding US Treasuries (Chart 3).

Chart 3: Composition of foreign assets

% of each country's total foreign assets



* "Other" includes trade credits , loans and financial derivatives

Source: China State Administration of Foreign Exchange (SAFE), data for 2011; US Bureau of Economic Analysis, data for 2011; Bank of Japan, data for 2011; UK Office of National Statistics, data for 2010.

Third, with the prospect of significant current account surpluses in the future, China's OFDI potential will be even greater.[4]

Chinese OFDI to Australia

Australia has been China's top OFDI destination since the start of the 'go global' policy, according to both official Chinese data and non-official data on Chinese cross-border transactions.[5] Unfortunately, official (Australian and China) data is affected by the widespread practice by Chinese

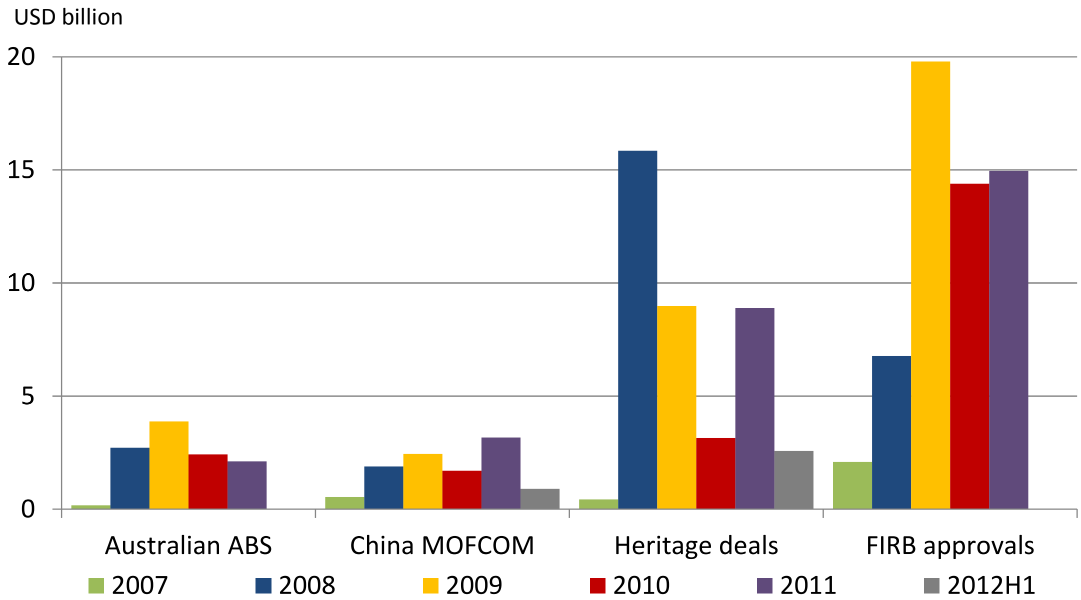
[4] IMF *World Economic Outlook*, April 2012, projects China's current account surplus rising from 2.3% of GDP in 2012 to 4.3% of GDP in 2017 (USD 540 billion). These projected surpluses may not eventuate if the Chinese Government is successful in rebalancing the economy towards more consumption and less investment. One estimate is for Chinese OFDI to be USD 1 to 2 trillion between 2011 and 2020. Daniel H. Rosen and Thilo Hanemann, *An American open door? Maximizing the benefits of Chinese foreign direct investment*, Asia Society, May 2011.

[5] Official data is from 2011 Statistical Bulletin of China's Outward Foreign Direct Investment, China Ministry of Commerce (MOFCOM), September 2012. Excludes Hong Kong and selected tax havens (Cayman Islands, British Virgin Islands and Luxembourg). Hong Kong is also excluded because of the likelihood that a significant proportion of flows could be channelled back into China. Transaction (principally Mergers and Acquisitions (M&A)) data is from Global Investment Tracker, Heritage Foundation, July 2012. Such transactions are a component of OFDI. Other components include greenfield investments and joint ventures. The Tracker includes global non-bond transactions by China over USD 100 million. An alternative source of M&A data from China to Australia is *Demystifying Chinese investment: China outbound direct investment in Australia*, KPMG and University of Sydney, August 2012. The KPMG data includes M&A transactions above USD 5 million. Despite the very different thresholds, the Heritage and KPMG data are very similar for each calendar year.

investors of sending their funds to Australia via third countries.[6] As a result, the final destination or origin of FDI is not always clear.

Numerous data sources provide a generally consistent picture of Chinese OFDI to Australia (Chart 4).[7] There was a rapid increase in investment flows, large transactions and Foreign Investment Review Board (FIRB) approvals after 2007, with some easing back in the growth rates after 2009. According to official Chinese data, there was a 43 per cent fall in OFDI to Australia in the first seven months of 2012, while total Chinese OFDI increased by 53 per cent.[8]

Chart 4: Chinese OFDI to Australia – alternative measures



Source: Australian Bureau of Statistics (ABS) years ending December; China Ministry of Commerce (MOFCOM) years ending December, MOFCOM 2012H1 data is estimated from non-financial flows in the first 7 months of 2012; Heritage Foundation, years ending December; FIRB, years ending 30 June. The AUD data is converted into USD at the calendar year or fiscal year (for FIRB) average exchange rate, sourced from the RBA.

Despite the rapid growth in Chinese OFDI to Australia in recent years, the stock of Chinese investment in Australia is still substantially below that of many other countries, especially the United

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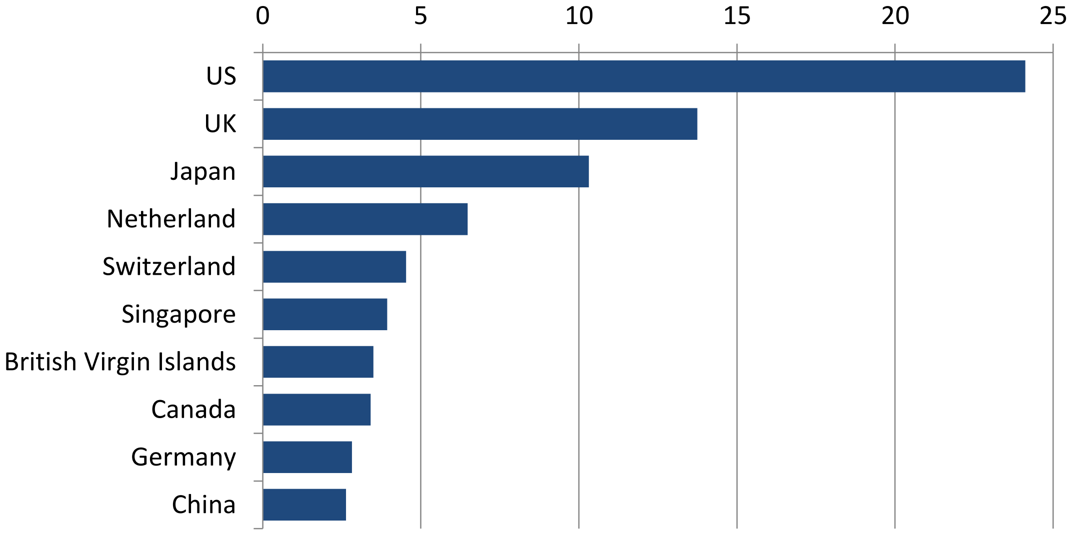
[6] The increasing importance of indirect FDI flows, Box 1.1, *World Investment Report 2012*, UNCTAD. Official Australian and Chinese data only record the immediately prior source or destination of FDI. This means that, for example, Chinese investment to Australia, channelled via Hong Kong, would be recorded by Chinese data as investment in Hong Kong. Australian Bureau of Statistics (ABS) data would also record the source of that investment as Hong Kong.

[7] While the pattern is broadly consistent, the differences in the levels are remarkable. ABS and MOFCOM data are broadly consistent, although MOFCOM data are around 15% below ABS data (on average). The difference between official (ABS and MOFCOM) data and Heritage deals data reflects the use of third countries to channel Chinese OFDI. (The spike in the 2008 data reflects the $13 billion Chinalco/Rio transaction, 80% of that year’s total.) The difference between official data and FIRB approvals flows from a number of factors, including the use of third countries; timing lags (between FIRB approval and investment); and some approved projects not proceeding.

[8] MOFCOM press conference, 16 August 2012.

States, United Kingdom and Japan (Chart 5). In 2011, China accounted for less than 3 per cent of total foreign direct investment in Australia.[9]

Chart 5: Top OFDI countries in Australia
% of Australia total OFDI stock in 2011



Source: ABS, Catalogue 5352. Note that the FDI stock for British Virgin Islands has been estimated from other published ABS data in Catalogue 5352.

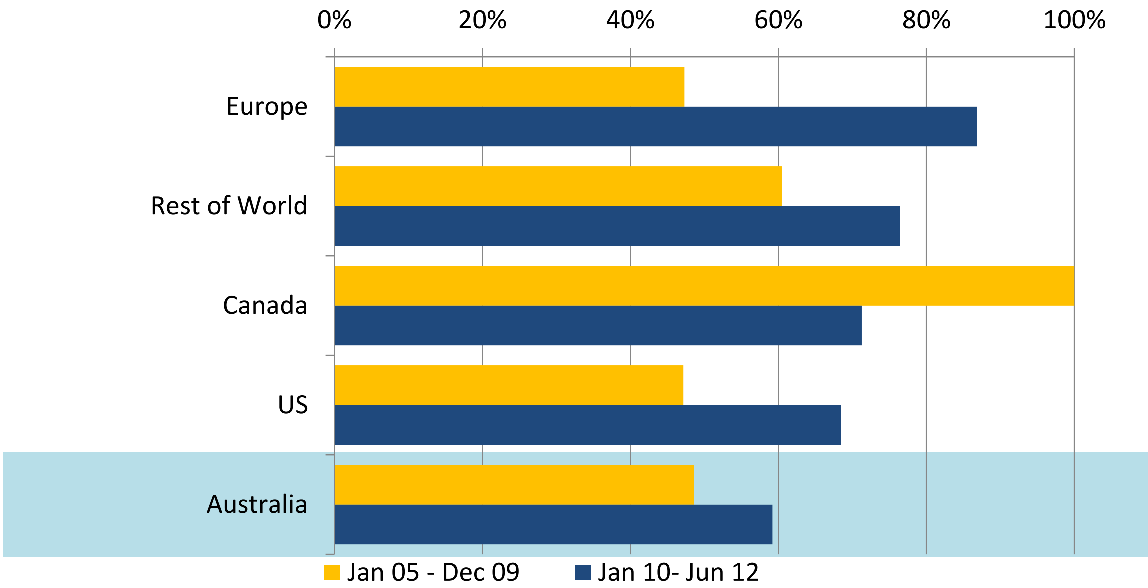
Transaction data from the Heritage Foundation also shows that Australia has a higher value and number of 'troubled' deals involving Chinese investment compared to other countries.[10] In recent years, Canada, the United States and Brazil have captured more large Chinese mergers and acquisition (M&A) transactions than Australia (Charts 6 and7).[11]

[9] If the Heritage data were to be used to estimate the China OFDI stock (and without adjusting any other country data), China's ranking would be fourth (behind US, UK, Japan), at around 9% of the total. Calculating China OFDI stock in this way would not take into account subsequent changes in equity positions or market valuations (as ABS data does).

[10] Troubled deals are defined by Heritage as failed transactions due to commercial and approval reasons.

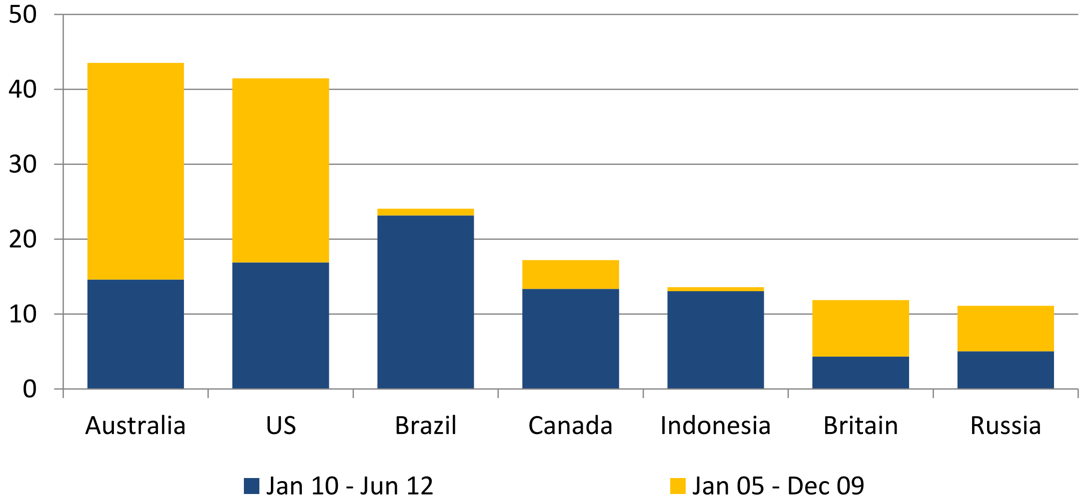
[11] Canada's relative position will be strengthened by CNOOC's (a Chinese SOE) proposed $15 billion takeover of Canada's Nexen (an oil and gas company). See Beijing's $15b Canada play in the spotlight, *Sydney Morning Herald*, 25 July 2012. As noted, MOFCOM and Heritage data can differ, including because of the use of third countries to channel Chinese OFD as well as Heritage only recoding transactions above USD100 million. The 2011 MOFCOM and 2012 Heritage data are consistent in showing the largest cumulative OFDI to Australia (excluding Hong Kong and two tax havens (Cayman Islands and British Virgin Islands) from the MOFCOM data). On the same basis, MOFCOM flows to Australia were the highest of all countries in 2008, 2009 and 2010. In 2011, flows from France and Singapore exceeded flows to Australia. In contrast to the Heritage data, MOFCOM flows to Canada, the US and Brazil were all less than flows to Australia since 2008.

Chart 6: China's OFDI transaction success rate by country/ region
Successful investment as % of total announced transactions over USD100 million



Source: Heritage Foundation, authors' analysis.

Chart 7: Top destinations of Chinese OFDI
USD billions, transaction value over USD100 million

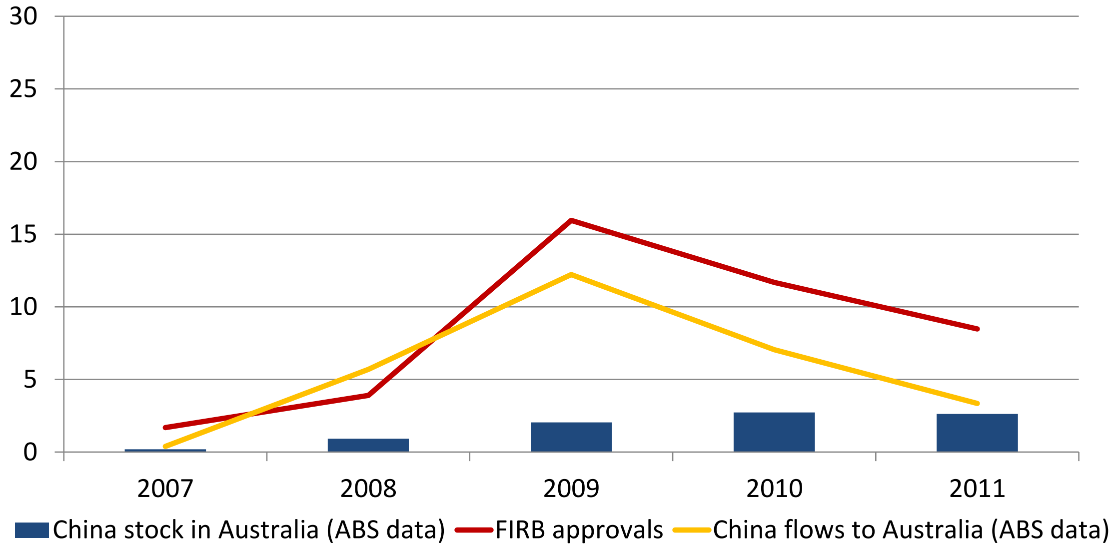


Source: Heritage Foundation, authors' analysis.

From both Australia's and China's perspective, while the stock of China OFDI has risen in dollar terms, the relative importance of Chinese OFDI flows, transaction deal flow and FIRB approvals have all eased back in recent years (Charts 8 and 9).

Chart 8: Australian perspective: how important is Chinese OFDI to Australia?

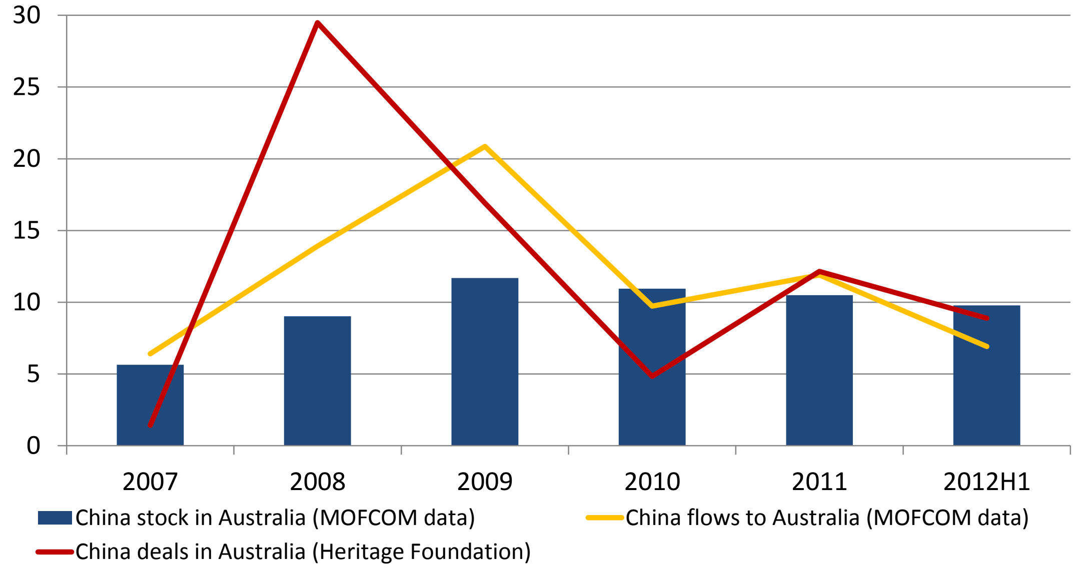
% of total FIRB approvals and % of total OFDI in Australia



Source: ABS, Catalogue 5352; FIRB Annual Reports. ABS data is for calendar year; FIRB data is for fiscal year.

Chart 9: China's perspective: how important is Chinese OFDI to Australia?

% of total Chinese OFDI (ex HK and Tax havens)



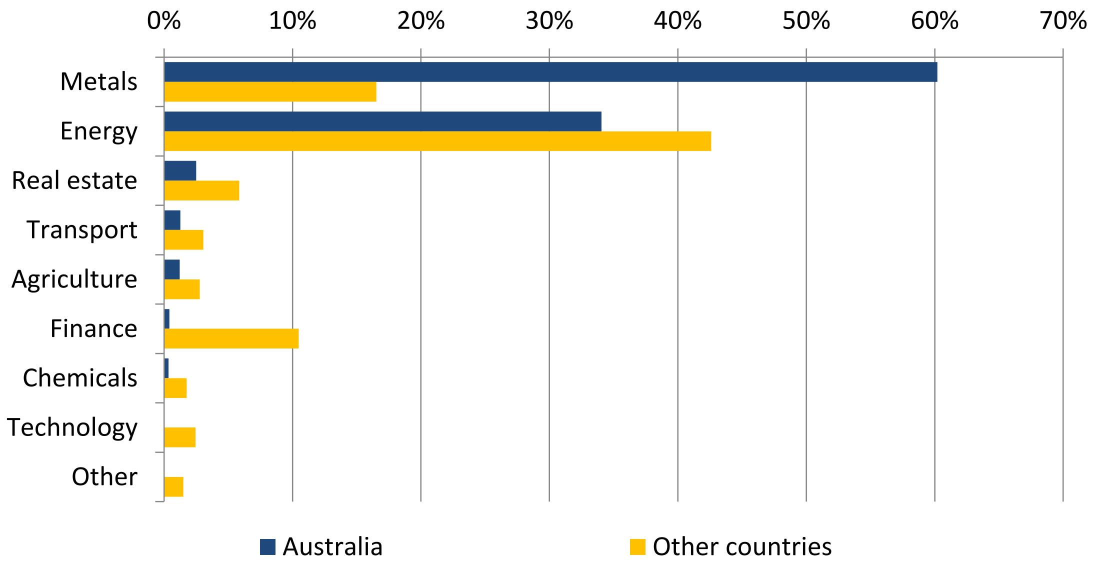
Source: MOFCOM 2011 Statistical Bulletin of China's Outward Foreign Direct Investment; authors' estimates for 2012H1 ; Heritage Foundation

Chinese investment in Australia has been concentrated in the minerals and energy sector (Chart 10).[12] Chinese investment in other countries has also been concentrated in minerals and energy, but has been more diversified than Chinese investment in Australia.

[12] This concentration is consistent with FIRB approvals – 83% of Chinese investment approvals in the three years to 2010-11 have been in the Mineral sector. Source: FIRB Annual Reports, 2007-08 to 2010-11.

Chart 10: Chinese OFDI in Australia and other countries by sector

Investment over USD100 million, Jan 2005 - Jun 2012



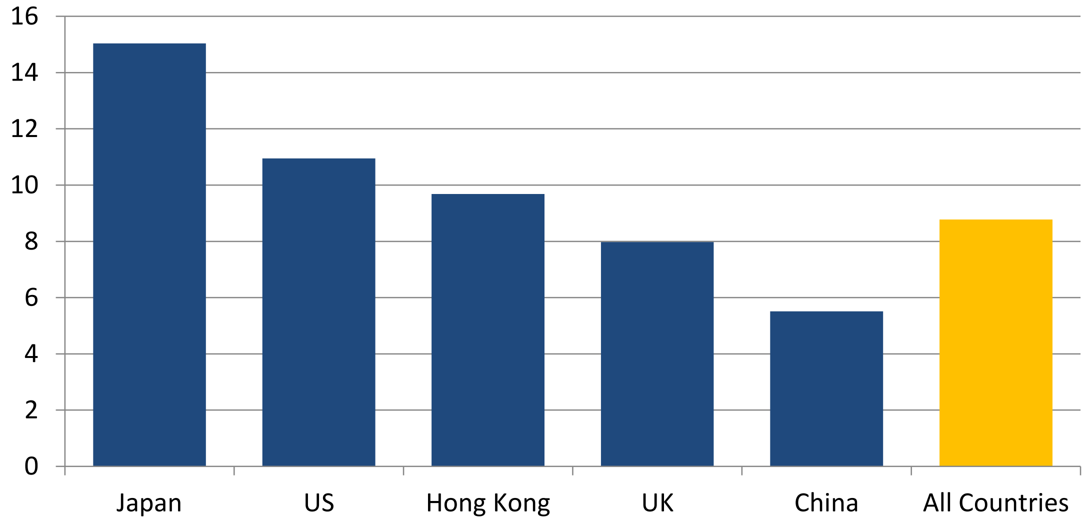
Source: Heritage Foundation, authors' analysis.

Why has there been a relative decline in Chinese investment in Australia?

The generally slower growth rate of Chinese OFDI to Australia in recent years reflects a range of factors. In recent years, China has been diversifying its OFDI, with less concentration in Australia, and Australian resources, in particular. One factor in this has been a greater Chinese capacity to execute a more diversified OFDI strategy, through the use of professional external advisers and more experienced internal execution teams. There has also been greater scrutiny by Chinese authorities of Chinese OFDI, especially after some high-profile poor deals, including in Australia. Perhaps reflecting some of those poor deals and the early stage of Chinese investments, the implied returns on Chinese OFDI in Australia have been lower than the returns from other major country sources (Chart 11).

Chart 11: Implied returns on OFDI in Australia

Average % of 3 year return on OFDI from selected countries



Source: ABS, Catalogue 5352. Implied returns are calculated as debit income flows as a proportion of the FDI stock at the end of the prior year.

A less tangible, but equally important, factor in the decline of Chinese OFDI in Australia may be the growing sense amongst Chinese investors of Australia's mistrust and discrimination. Since 2008 a number of events have helped create this impression. Starting in 2008, a number of high-profile Chinese investment proposals were either blocked or were substantially modified by the Treasurer, following FIRB advice (Chinalco/Rio, Lynas, Oz Minerals/Prominent Hill).[13] In response to public concerns, the Australian Government set out additional FIRB considerations when assessing applications from SOEs and Sovereign Wealth Funds (SWFs). These included: the investor's independence from government; whether the investor has clear commercial objectives; corporate governance practices; and whether an investment may hinder competition or lead to undue concentration and control.[14] These additional considerations have led to the imposition of conditions (or 'undertakings') by the Treasurer on Chinese (and other) investors. Such conditions include: local listing requirements; the number of Australian-based directors; where meetings and decisions by directors are made; as well as specific requirements that contracts be made on an arm's length basis. All this is designed to counter the potential risk of non-commercial behaviour and/or the risk of non-arm's length transactions. [15]

These additional FIRB guidelines were widely seen to be primarily directed at Chinese investment and Chinese SOEs in particular. This seemed to be confirmed by a US diplomatic cable released by WikiLeaks in 2011. In September 2009, a speech by the then head of FIRB to an Australia China Business Council conference appeared to set out new and even more restrictive guidelines for Chinese investment. All of this coincided with significant commercial and operational problems experienced by a number of Chinese investments in Australia, as well as broader tensions in the relationship, including over then Prime Minister Rudd's comment about human rights in China, and the arrest and trial in China of Rio Tinto executive, Stern Hu. [16]

Possibly in response to these problems, the nature of Chinese investment in Australia began to change. There were fewer mega-deals and Chinese investors took lower equity stakes. There were more joint ventures and more indirect (portfolio) investments. The Chinese also took steps to improve the operations of their investments in Australia by employing more local management and better public communication.

Nevertheless, new issues continued to have an impact on Chinese perceptions of Australia as an investment destination. Chief amongst these was the Government's decision in 2011 to exclude China's Huawei from tendering for the National Broadband Network (NBN). While the Australian Government argued that this decision was based on 'security' grounds, it was widely seen by those

[13] See *Chinese perspectives on investing in Australia*, p 14.
[14] Government improves transparency of foreign investment screening process, Treasurer, Media Release, 17 February 2008.
[15] Such conditions are not confined to SOEs. See, for example, the conditions imposed by the Treasurer on the sale of Cubbie Station to a Chinese-Japanese consortium in August 2012.
[16] More detail on some of the commercial and operational problems is provided in Enter the dragon – only to get burnt, *Sydney Morning Herald*, 14-15 July 2012.

we spoke to in China as driven by American pressure.[17] This was followed by a politically charged discussion of foreign, and in particular, Chinese ownership of agricultural land and agribusiness.

It was not just government statements or actions that helped create the impression in China that their investments were unwelcome in Australia. In July 2012 Opposition Leader Tony Abbott commented in Beijing that ‘it would rarely be in Australia’s national interest to allow a foreign government or its agencies to control an Australian business’.[18] A discussion paper released by the Federal Opposition on foreign investment proposed lowering the FIRB threshold for approving acquisition of rural land from the current $244 million for non-foreign government-related entities to $15 million.[19]

In addition to these new issues directly bearing on trust, Chinese contacts point to a catalogue of macro issues that have made Australia a less favourable investment destination: the Minerals Resource Rent Tax (MRRT); the carbon tax; inadequate infrastructure; high labour costs; lack of skilled labour; and the high Australian dollar. Of course, these macro issues affect all investors (both local and foreign), but the MRRT was singled out as being particularly adverse to China, given the recent and significant investments in Australia’s mining industry.[20] The MRRT was seen by Chinese contacts as raising ‘sovereign risk’ for Australia.[21]

Mixed messages

The Australian Government cannot always be held responsible for the way in which these events have been interpreted or even misinterpreted in China. But the Government, and the Federal Opposition, do bear a responsibility for sending mixed messages to the Chinese. On the one hand, both the Government and Opposition have consistently said that they welcome Chinese investment. For example, Australian Foreign Minister Bob Carr recently reassured Beijing that ‘Australia welcomed Chinese investment’, whilst Opposition Leader Tony Abbott said in an address to AustCham Beijing that ‘an incoming Coalition government would welcome Chinese investment on the same basis that we welcome investment from other countries’.[22] On the other hand, this welcome has been heavily qualified when it comes to their treatment of specific instances of Chinese investment, illustrated by many of the cases above. Some amongst our Chinese interlocutors said they do not feel truly welcome in Australia, contrasting the country negatively with other countries, especially Canada, in recent years. When pressed further, China contacts often refer to a lack of trust between Australia and China, reflecting the poor understanding of different political systems, development history, business practice, and the fact that SOEs are the major vehicle for Chinese OFDI.

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[17] The Australian decision to exclude Huawei also appears inconsistent with a number of other countries, including the UK, which has accepted Huawei as a provider of significant communications infrastructure. See Huawei’s NBN ban needs review, says Turnbull, *Australian Financial Review*, 28 August 2012.
[18] Abbott warns China on takeovers, *Australian Financial Review*, 25 July 2012.
[19] “The Coalition’s policy discussion paper on foreign investment in Australian agricultural land and agribusiness”, August 2012.
[20] In a recent survey, a number of these issues were reported as leading to less investor confidence in Australia by international companies. See Global CEOs challenge Labor, *Australian Financial Review*, 15 August 2012.
[21] Also see Australia seen as sovereign risk: ex-China Ambassador, *Business Spectator*, 9 August 2011.
[22] Australia welcomes Chinese investment, *International Business News*, 14 May 2012. Working harder on a complex relationship, *Tony Abbott’s China speech at AustCham Beijing*, 24 July 2012.

One reason for the mixed messages coming from Australia's political leaders is negative public attitudes towards Chinese investment. In the 2012 Lowy Institute Poll some 56 per cent of respondents thought that Australia was allowing too much investment from China. When asked further about the reasons for that view, respondents cited (amongst other things) concerns about ultimate Chinese government control of Chinese investment and the potential for China to use its Australian investments as leverage if there was a future conflict in the region. There was also a strong view that the Australian Government was allowing too much foreign investment, not just from China.[23]

Australia's business leaders have, however, been more welcoming of Chinese investment.[24] Australia's state premiers have also generally been more positive than their Federal counterparts.[25]

Misunderstanding

Negative attitudes towards Chinese investment seem to be heavily influenced by the nature of China's political and economic system. There is a strong perception that allowing investment in Australia by Chinese SOEs will in some way give the Chinese Government control or influence over those assets. Reflecting public and political concerns, for example, an SOE's independence of its home government is an explicit consideration in FIRB assessments.[26]

The history, role and evolution of Chinese SOEs and their relationship with the Chinese Government need to be better understood. In particular, there is less government influence over SOEs than some believe and most are run on a completely commercial basis (see Box 1). A 2011 Asia Society report said that 'China's firms typically put self-interest and profitability above all else'.[27] China's National Development and Reform Commission (NDRC), which approves SOE applications for large OFDI transactions, now has a heightened focus on commerciality and risk management. Some Chinese contacts concede that SOEs *operating in China* may need to take into account broader Chinese government policies (such as maintaining employment and regional expansion). But even critics of Chinese SOEs operating offshore struggle to find examples of non-commercial behaviour, although they emphasise the *potential* for such behaviour.

It's true that similar FIRB scrutiny would be applied, for example, to SWFs from Singapore or the United Arab Emirates.[28] The difference, of course, is that SWFs tend to take much lower equity stakes and do not manage commercial operations (as many Chinese SOEs do). Further, SWF investment does not usually raise concerns about vertical integration and the potential for related

[23] There was less agreement with the statement 'it is hard to trust China'. However, it seems that many of the other responses point to a lack of trust. At an even broader level of 'trust', while 58% of respondents agreed that it is unlikely that 'China will become a military threat to Australia in the next 20 years', a sizable minority (40%) saw it as likely.

[24] In an article on 6 August 2012 entitled Business building bridges to China to repair ties, *The Australian* newspaper reported that Australian business leaders 'have seized the initiative on ties with China, starting a "desperately overdue" dialogue after becoming exasperated with what they view as Labor's mishandling of the country's most critical bilateral relationship.'

[25] Liberal premiers at odds with Tony Abbott on China investment, *The Australian*, 25 July 2012.

[26] Treasurer, Media Release, 17 February 2008.

[27] *An American open door?,* Asia Society, 2011. This is also consistent with the KPMG report cited above.

[28] A number of US and UK banks, with substantial (post GFC) government equity ownership, would also be assessed under these guidelines, as would some large European corporates.

party transactions (and transfer pricing), unlike SOEs. Such concerns are heightened because Australia's resources sector has been the primary sector of Chinese SOEs investments – and resource security is a Chinese government-targeted 'go global' objective.

BOX 1: The role of SOEs in the Chinese economy

The history and role of SOEs in the Chinese economy

Before China opened up in 1978, all Chinese businesses were government-owned and operated. In 1988, a new Company Law removed the government's direct control over SOEs, granted legal status to SOEs and defined the state as an owner. By the end of the 1990s, most SOEs were corporatised (and run on a commercial basis) and registered under the Company Law, separating the company owners from company management. In this period, over 5,000 SOEs filed for bankruptcy.

The Shenzhen and Shanghai stock exchanges started trading in 1990, providing a channel for continued SOE reforms. The number of listed companies increased from 10 in 1990 to over 2,000 in 2010. Around 70 per cent of listed companies in China still have state or provincial SOE shareholders.[29] The Company Law was revised in 2006 to provide more security to minority shareholders. Recent reforms provide more shareholder protection. The introduction of 'Corporate Social Responsibilities' as SOE management guidelines to promote economic development, social progress and environment protection indicates less flexibility on employment decisions for SOEs.

Since 1978, China's corporate sector has transitioned from purely SOE businesses to a mix of SOEs, public (that is, listed) companies, private companies and foreign companies. During this transition, there has been a significant decline in state employment (from 72 per cent of urban employment in 1996 to 21 per cent in 2010.)[30]

Typical governance structure of SOEs

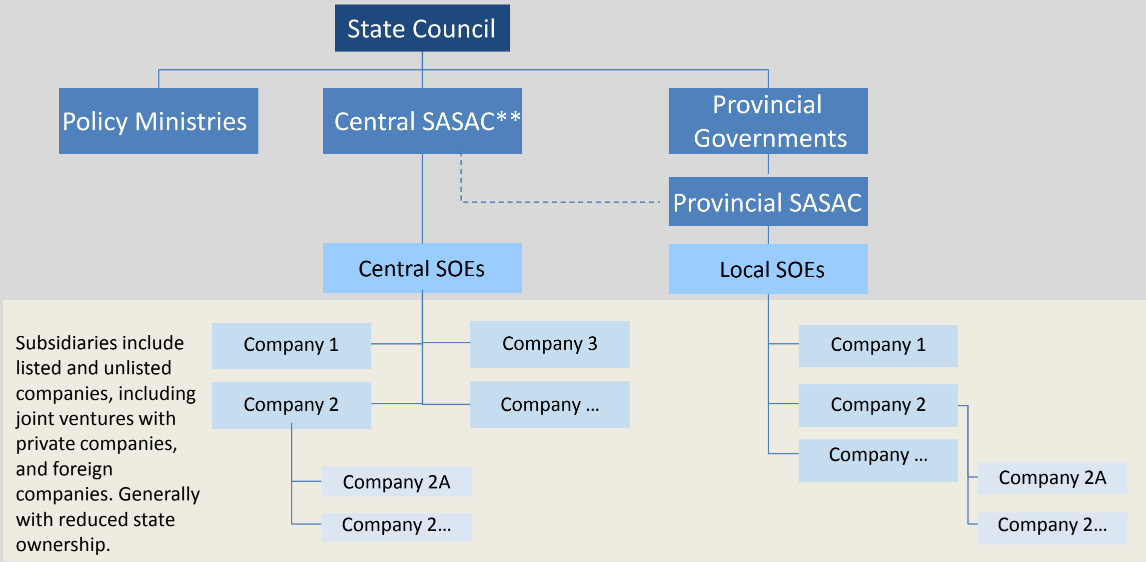
The ownership structure is set out in Chart 12. The State-owned Asset Supervision and Administration Commission (SASAC), created in 2003, manages non-financial SOEs registered under the Company Law 'on the principle of separating government administration from enterprise management and separating ownership from management.' SASAC reports to the State Council. There are 117 Central (or national) SOEs managed by Central SASAC. Provincial governments have their local SASAC supervising the provincial SOEs. Both Central and provincial SOEs could have wholly or partially owned subsidiaries or listed entities. Some also have joint ventures with foreign investors or privately-owned companies. These subsidiaries have government shareholding but are normally not directly governed by SASAC. These subsidiaries could be listed domestically or offshore (especially in Hong Kong, but also in New York and London). Many have non-majority ownership by the ultimate parent SOE.

The Chinese Government, through SASAC, exercises its ownership control and influence on SOEs by the appointment of Board members and approval of the appointment of senior executives, rather than by managing day-to-day business activities. The Organisation Department of the Communist Party plays a role in the approval of the top executives of Central SOEs.

[29] Stock market redesign and listed SOEs, *Shanghai Securities News*, 18 May 2012.

[30] Source: China Bureau of Statistics. State employment includes state-owned enterprises, government and social organisations.

Chart 12: The structure of Chinese SOEs and the associated companies*



* Apply to non-financial services sector SOEs
** SASAC refers to State-owned Assets Supervision and Administration Commission

There are top executive movements between the SOEs, the Ministries (and regulators) and even the State Council.[31]

SOEs abroad are behaving more like international corporations and SOE senior management are also assessed based on financial/shareholder returns.[32] That said, the Chinese Government can also influence SOEs to contribute to government policies, such as the Government's five-year plans, economic stimulus plans, 'go global' policy, and greater Chinese regional development, generally on a commercial basis.

The Government encourages SOEs to compete with each other, including at the early (but not later) stages of OFDI proposals. Both Chinese and Australian contacts confirm the intense competition among SOEs in China.

Whilst the role of SOEs is evolving, the Government has pushed SOEs towards more governance transparency, better financial performance, more management accountability and more social responsibilities. Chinese government websites (including SASAC) provide information on these developments. However, given that most of this information is only available in the Chinese language, these improvements in corporate governance may not be widely understood beyond China.

The role of SOEs and their associated companies in Chinese OFDI

With a few notable exceptions[33], most significant Chinese OFDI transactions have been made by SOEs or by companies with at least one SOE shareholder. Whilst private companies[34] have emerged and grown very quickly in the past decade, SOEs and their subsidiaries still generally have more experience and capacity to manage OFDI operations and risks. In addition, these companies tend to have more financial capacity, including better access to finance from Chinese policy and commercial

[31] For example, the President of Chinalco was promoted to the State Council in 2009.

[32] *Demystifying Chinese investment: China outbound direct investment in Australia*.

[33] Such as Geely and Huawei.

[34] While 'private' would usually be defined in terms of being 'non-government', the Huawei example shows that even private Chinese companies can raise concerns about possible non-commercial behaviour.

banks. Reflecting these factors, Heritage data shows that private companies have a higher failure rate than SOEs in offshore transactions.

According to the Heritage Foundation database, over 80 per cent of Chinese offshore transactions over USD100 million are by companies with at least one Chinese central or provincial SOE shareholder. In Australia, KPMG estimates that SOE investment accounts for around 80 per cent by number and 90 per cent by value of total deals.[35]

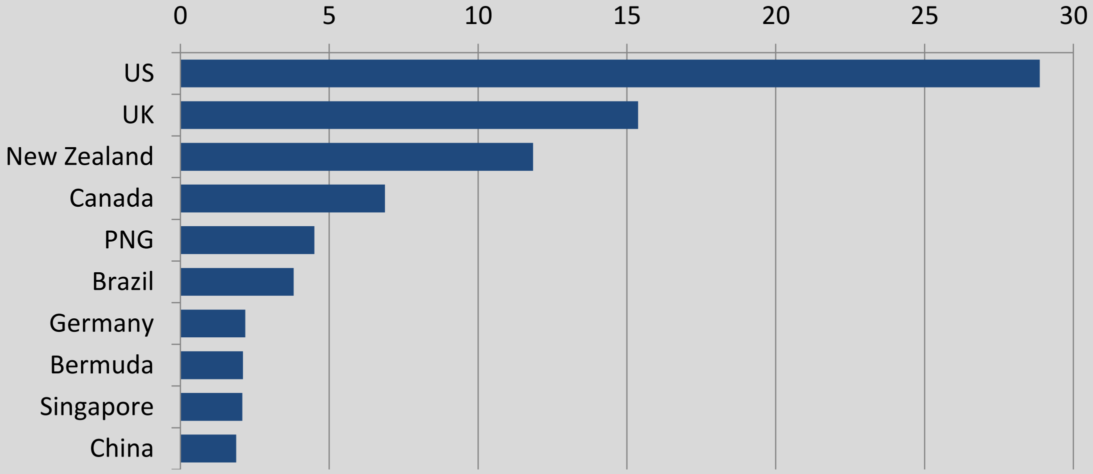
Misunderstanding can also flow from the differences in business practices, institutions and culture between the two countries, and between China and Western countries more broadly. While these culture gaps have undoubtedly contributed to issues in the investment flows from China to Australia, they seem more significant for the investment flow from Australia to China (see Box 2).

BOX 2: Australian OFDI to China

From the perspectives of both Australia and China, Australian OFDI to China is relatively minor: 1.9 per cent of Australia's stock of OFDI[36] and less than 1 per cent of Chinese inward FDI.[37] Australia's OFDI is concentrated in other Western countries (Chart 13).

Chart 13: Australian OFDI destination

% of Australia total 2011



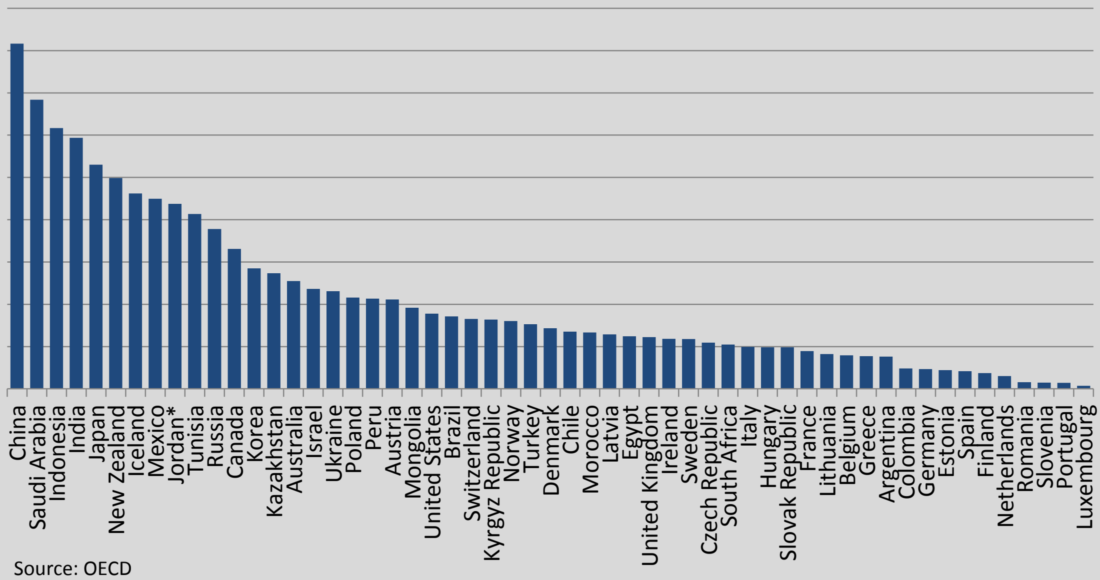
Source: ABS Catalogue 5352. Note that the FDI stocks for PNG and Bermuda have been estimated from other published data in Catalogue 5352.

Why is that so?

According to the OECD, Chinese investment barriers are the highest of the 55 countries that are measured. Asian countries and resource-intensive countries (such as Canada and Australia) also have relatively high barriers (Chart 14).

[35] *Demystifying Chinese investment: China outbound direct investment in Australia*.
[36] ABS, Catalogue 5352. This proportion has gradually risen from 0.4% in 2006.
[37] MOFCOM data shows Australian flows of inward FDI were less than 0.5% of the total in each year from 2007.

Chart 14: OECD FDI Regulatory Restrictiveness Index 2012

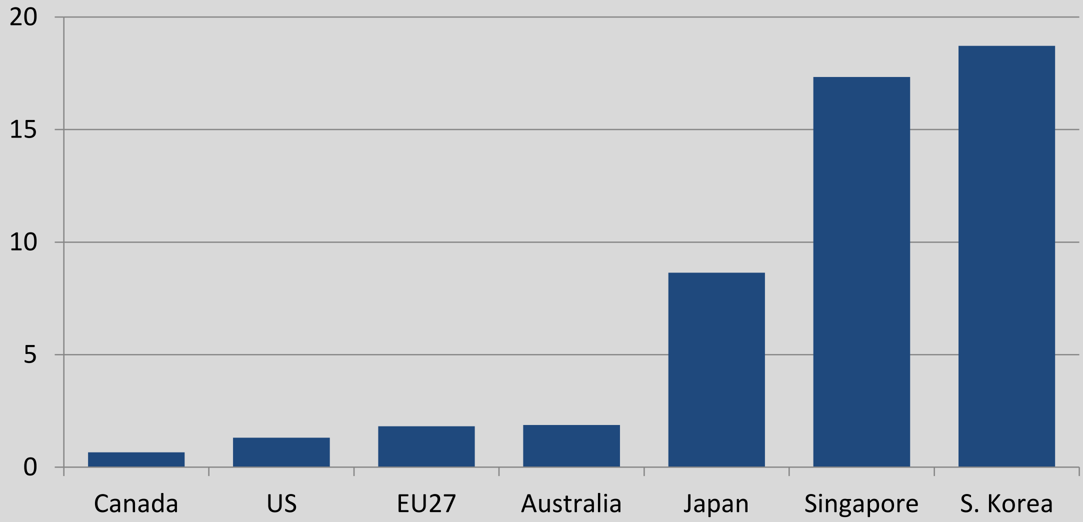


Source: OECD

In addition, foreign investors into China face a range of 'behind the border' issues, including concerns about inconsistent regulatory interpretation/unclear laws; difficulty obtaining licences; corruption; bureaucracy; intellectual property rights infringement; and national protectionism.[38]. However, a number of key Asian countries have invested a much greater proportion of their OFDI in China, despite facing the same barriers (Chart 15).[39]

Chart 15: OFDI to China

% of each country's total OFDI



Source: European Commission, Eurostat, data for 2010; ABS, data for 2011;US Bureau of Economic Analysis, data for 2011; Bank of Japan, data for 2011; Singapore department of statistics , data for 2010; Statistics Canada, data for 2011; Korea Eximbank, data for 2012.

This suggests that there are other factors – such as proximity and cultural issues – affecting Australian investment in China. A study of Australian businesses in China ranked differences in

[38] *2012 American Business in China White Paper*, American Chamber of Commerce in China (Amcham), April 2012.

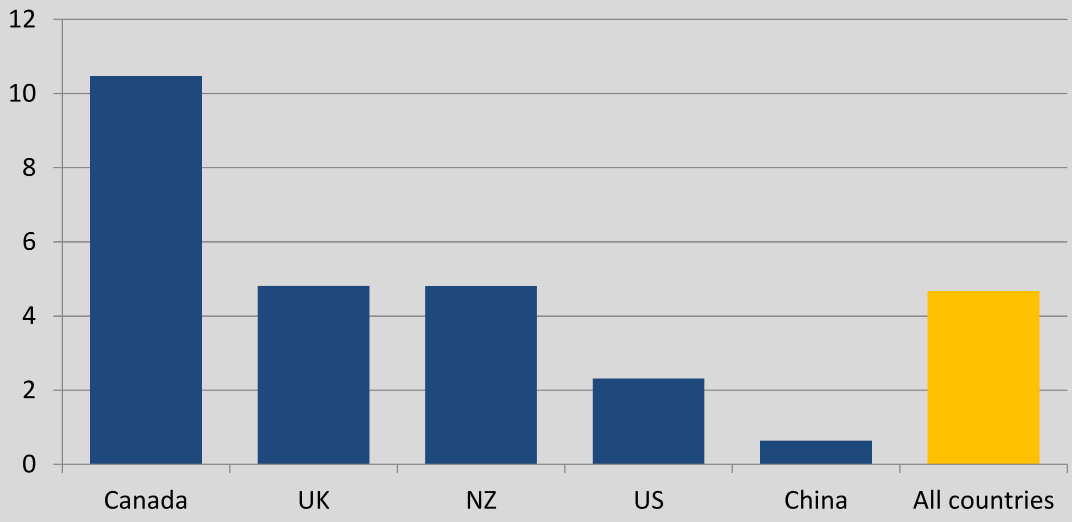
[39] The OFDI proportion for Taiwan and Hong Kong is significantly higher than the countries in Chart 14.

cultural norms between the Australian companies and the Chinese staff they employed as a more important consideration in establishing a business in China than operational issues such as the opaque legal system and archaic and complex banking rules and regulations.[40] Asian companies appear much more culturally comfortable in China, as reflected in their significantly higher OFDI proportions in China. Also, Australia's largest companies (concentrated in resources and finance) are in sectors that face relatively high Chinese investment barriers. Another large sector (retail) is domestically focused.[41] Australia has limited manufacturing capacity, where Chinese investment barriers are relatively lower.[42] Many Australian small and medium enterprises (SMEs) in those non-resource and finance sectors may lack the capacity to enter the China market and build business over the longer term.[43] Recent annual Amcham surveys show that, despite their complaints, most US businesses in China are profitable – the more so the longer they have been in China.[44] It may be that Australian companies lack the necessary patience or capacity to take a longer-term view of investing in China. Some contacts also point to the conservatism of Australian company boards and a lack of understanding of Asian cultures.

Australia's investment in China has also produced relatively poor returns, although this could partly reflect the short time-frame and relatively small scale of many investments (Chart 16).[45]

Chart 16: Implied return on Australia's OFDI

Average % of 3 year return to 2011 from selected countries



Source: ABS Catalogue 5352. Implied returns are calculated as credit income flows as a proportion of the FDI stock at the end of the prior year. Note that some credit income data is not published (China for 2009 and 2011; Canada for 2010 and 2011; and UK for 2011). Authors' analysis. The FDI stock is not published for 2008 for Canada and China. The missing data has been derived from published flow and stock data. The calculated implied returns for countries with unpublished data should therefore be treated with additional caution.

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[40] Menzies, J. et al, *Doing business in China: how Australian companies make their decisions when entering the China market*, Deakin University, 2008, as quoted in *Engaging China: the realities for Australian Business*, Australian Business Foundation, 2009.
[41] Property developer Westfield has extensive investments offshore but not in China.
[42] Data on the sectoral composition of OFDI, by country, is very limited. A notable exception is Japan. For Japanese OFDI in China, 74% is in the manufacturing sector, compared with 47% of Japan's total OFDI. Source: Bank of Japan.
[43] Australian architectural and engineering consulting firms are examples of success.
[44] According to the AmCham surveys, US businesses in China are concentrated in services (including IT) and manufacturing.
[45] The average investment size of Australian OFDI in China is 26% of the average of all OFDI in China. Source: MOFCOM, 2011.

What should be done?

Foreign (including Chinese) investment in Australia should face scrutiny. Part of FIRB's role is to give the Australian public confidence that foreign investment is taking place in the 'national interest'. Both major Australian political parties are supportive of foreign investment, but recognise that public opinion is often more negative (as demonstrated by the Lowy Institute Poll results). This means that, at times, additional scrutiny of foreign investment is warranted to maintain that public confidence. The additional FIRB guidelines for SOEs and the possible lower thresholds for approval of foreign investments in rural land and agribusiness (as proposed by the Opposition paper on foreign investment) could be seen as a response to those public concerns.

Nevertheless, there are still things that the Australian Government should do to reduce perceptions that it does not welcome Chinese investment, the mixed messages it sends and the misunderstandings surrounding the investment relationship. Given that there is broad consensus about the importance of foreign investment, including from China, there is a strong national interest in doing so, especially when other countries may be relaxing their foreign investment regimes.[46] There are also, obviously, broader reasons to ensure that tensions in the investment relationship do not have an impact on the broader political relationship and vice versa.

Better communication and more engagement

One key step that both sides could take to improve the investment relationship is to improve the levels of government communication and engagement. Senior Australian economic and trade ministers are already frequent visitors to China. The Treasurer and the NDRC already have a 'High Level Economic Dialogue', although this falls short of a higher level 'Strategic and Economic Dialogue', such as that between the United States and China. Formalising the Australia China Economic and Trade Cooperation Forums (ACETCF) at a government to government level would also be a positive, including by allowing more exposure of Chinese SOEs to Australian government Ministers and officials.[47] Further, more could be done at the bureaucratic level, such as building deeper connections between the Australian Treasury Department, within which the FIRB sits, and Chinese investment-related departments/authorities (particularly MOFCOM, NDRC and SASAC)[48] as well as influential academics and think tanks.[49] These linkages should be stronger not just between officials in China, but very importantly, also in Australia. Stronger linkages should facilitate a more

[46] Canada's foreign investment 'net benefit' test (the applicant must demonstrate a net benefit) appears more restrictive than Australia's 'national interest' test (the investment should be allowed unless it is contrary to the national interest). A recent Canadian report (*Fear the dragon? Chinese foreign direct investment in Canada*, The Conference Board of Canada, July 2012) advocates that Canada adopt Australia's more liberal approach. In addition, the Canadian Government will gradually increase the review threshold from $C330 million to $C1 billion over four years, for WTO member countries (including China) and regardless of ownership. Source: Government of Canada News Centre, 25 May 2012. Existing guidelines require the governance and commercial orientation of SOEs to be considered but (unlike Australia) the review threshold is the same for SOEs.

[47] ACETF is officially organised by the Australia China Business Council (ACBC) and has been attended by Xi Jinping, Li Keqiang, Kevin Rudd and Prime Minister Julia Gillard, as well as 1000 company executives from both countries.

[48] Relevant departments within NDRC would include Department of Foreign Capital and Overseas Investment. Relevant departments within MOFCOM would include Department of Outward Investment and Economic Cooperation (outbound investment), Department of Foreign Investment Administration (inbound investment) and Department of American and Oceania Affairs (country policy).

[49] Including those who are quoted in the Chinese media criticising Australian investment policy.

active approach to communication of investment policy changes to China – a 'pick up the phone' mentality, giving advance notice or early explanation of Australian government policy or statements. This could have helped to ease tensions in the past when new policy or guidelines were announced that were seen by China as discriminatory.

FIRB has been at the forefront of Chinese concerns about discrimination, although those concerns have eased in the last year or so. It is not well understood in China that FIRB is an advisory body and the Treasurer makes the final decision regarding investment applications. A more proactive and regular presence in China by FIRB would help to better explain the process (especially the treatment of SOEs) and emphasise the higher-level 'welcome' message.[50] In particular, while flexible rules and a case-by-case approach have served Australia well, such flexibility can be interpreted in a discriminatory way.[51]

Another element in Australia's efforts to better communicate its policies and interests to China would be a far less politicised and better informed discussion of Chinese and, indeed, all foreign investment in Australia. Australia's political leaders have a key role to play here. Australia's two major political parties publicly support foreign investment, including Chinese investment. This is usually (and appropriately) qualified by reference to the 'national interest' test through FIRB. But it can be tempting for the Opposition of the day (whichever party that may be) to exploit public concerns about foreign investment, and Chinese investment, in particular. That may garner some temporary political support but it can also unnecessarily complicate Australia's investment relationship with China.

Regulatory steps

In addition to better communication, there are regulatory steps that both sides could take to improve the investment relationship. As we have already noted, at times the imposition of additional conditions on Chinese SOEs by the Treasurer (as advised by FIRB) has been an irritant to Chinese investors and has formed part of the 'discrimination' story. One alternative would be less direct intervention in corporate governance at the FIRB approval stage and more reliance on Australian domestic regulatory authorities to ensure appropriate behaviour and outcomes. For example, concerns about non arm's length or transfer pricing could be managed by the Australian Taxation Office (ATO). Misuse of market power could be managed by the Australian Competition and Consumer Commission (ACCC) and broader issues with corporate governance, by the Australian

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[50] FIRB has taken a more active approach in China since late 2011, with visits by FIRB's Executive Member (November 2011) and, more recently, by FIRB's new Chairman. But, prior to those visits, FIRB was not active in China. It is also worth noting that, during that recent visit, the FIRB Chairman was reported as telling his Chinese audience that 'Australian businesses, however they are owned, should be run on a purely commercial basis and not as an extension of the policy, political or economic agenda of a foreign government.' FIRB says foreign investors must not be driven by political agenda, *The Australian*, 6 August 2012. This is a very important message for China – but needs to be presented in a way that does not imply a suspicion or presumption of non-commercial behaviour.

[51] Flexibility could lead to fears that politicians can be influenced by popular pressure because of the vagaries of the 'national interest' test. A visiting China academic said the Australian Government appeared to make up regulations when facing populist pressures. See China calls for deeper ties, *Australian Financial Review*, 31 July 2012.

Securities and Investments Commission (ASIC).[52] The advantage is that these authorities regulate all Australian businesses, regardless of ownership (domestic or foreign). That should help to ease Chinese discrimination concerns.

China also has a role to play here. Concern about potential non-commercial behaviour by Chinese SOEs is not just an issue for Australia but for many other countries. China could ease many of these concerns by continued SOE reform towards greater market-oriented structures, including privatisation.[53] Even though many SOEs are listed on stock exchanges, substantial proportions of equity are still held by the Chinese Government (national or provincial). The higher the government proportion, the greater the concern foreign governments will have about potential non-commercial behaviour. China could also improve SOE corporate governance and transparency by appointing more (and truly) independent directors and imposing stricter rules on related party transactions. SASAC has provided substantial public information on SOE management in the Chinese language, targeting local stakeholders. More information should be provided in English, targeting international stakeholders.

Infrastructure and agricultural cooperation

What often seems to be lost in the discussion of the Australia-China investment relationship are the real benefits to Australia. One way to both exploit those benefits and strengthen the investment relationship more generally would be through greater government-to-government cooperation on investment in two particular sectors where China and Australia have particular complementarities – infrastructure and agriculture. Government-to-government cooperation would be essential to advance these initiatives because of the regulatory complexities, as well as the political sensitivities.

China has significant experience in the infrastructure sector, while Australia has a substantial backlog of projects, particularly those that require some explicit or implicit public subsidy, such as rail and roads.[54] This backlog is a drag on long-term productivity, as well as public amenity. China could provide capital (equity and debt),[55] along with considerable expertise in infrastructure construction. China could also provide materials and skilled labour, if those were constraints in Australia.[56] There are a number of models, all of which could involve significant Chinese participation in both financing and construction in partnership with local firms.[57] Chinese involvement in Australian infrastructure

[52] A report to the Business Council of Australia (BCA), *Foreign attraction: building on our advantages through foreign investment*, 2010, also raised this alternative approach.
[53] This is the recommendation in *China 2030: building a modern, harmonious and creative high-income society*, World Bank, February 2012. The Overview of this report notes the 'suspicion' towards Chinese OFDI.
[54] Full cost recovery is usually not possible. Government subsidies can be justified by the positive externalities of such infrastructure – such as less congestion and pollution. Governments therefore need to ensure appropriate revenues to provide such subsidies.
[55] The debt financiers for infrastructure projects are traditionally European banks. The GFC has seen many European banks exit or reduce their exposure to the Australian infrastructure market.
[56] One argument for limiting public infrastructure at the current time is that the skilled labour is needed for mining infrastructure development. A significant increase in public infrastructure at the same time as the mining infrastructure boom could see pressures on the skilled labour market and materials prices.
[57] One would be recycling funds from brownfield infrastructure – for example, selling power stations to fund roads and rail. (The NSW Government is currently considering this option. The NSW Premier was recently in China promoting the opportunity for Chinese investors.) Chinese investors could be purchasers of the assets, infrastructure financiers and constructors. Another model (which could overlap with the first) is Public Private Partnership, although there is a poor history of private investor returns because of lack of risk sharing on

financing and construction stages could be considered under the recently signed infrastructure MoU between Australia and China.[58]

Chinese investment could also play an important role in developing Australian agriculture, providing capital, technology and new markets, and helping to develop new products. There is already a joint Australian-China study to examine policy changes needed to facilitate large-scale investment in undeveloped land in northern Australia.[59] But a joint Australia-China agriculture initiative could be much broader. Chinese capital could make an important difference, not just for farming but also further up the value-add chain, such as sugar refineries.[60] China is already investing in farms and agribusinesses but is facing strong public concern, fuelled by some media and politicians about foreign land ownership and Australia's food security.[61] This is despite the fact that only 6 per cent of rural land is foreign owned and Australia exports over 50 per cent of its agricultural production.[62]

Wrap up FTA negotiations

Finally, the negotiations for an Australia-China FTA need to be drawn to a pragmatic conclusion, after eighteen rounds and seven years of talks. There may be sufficient agreement to allow real market opening in some areas in a way that would fall short of a formal 'FTA' but which could still constitute a meaningful agreement. Concluding these talks with an agreement (of sorts) would, at the very least, free up economic and diplomatic resources to develop higher return relationships with China, including those suggested above.

Related to the FTA is the issue of reciprocity, which is an ideal that should not be allowed to stand in the way of mutually beneficial trade and investment. In particular, Australia should not block foreign investment into certain industries just because China does. Insisting on reciprocity as a precondition for Australian action would have prevented one of the great Australian economic reforms of the 1980s and 1990s – tariff reductions.

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revenues (traffic flow) and significant cost escalation. To improve the return for equity investors, the industry groups have suggested different approaches, such as 'externality value capture' – for example, allowing the private sector to capture some of the higher value of rail corridor land.

[58] Australian Minister for Infrastructure and Transport, and Chinese Ministry of Commerce signed an MoU to enhance cooperation in infrastructure construction in the two countries. A working group will be established, however the membership and timing are yet to be determined. Australia and China Strengthen Cooperation on Infrastructure, Minister Anthony Albanese's media release, 10 April 2012.

[59] Labor's China food bowl plan, *Australian Financial Review*, 31 May 2012. The report cites one possible area for cooperation as having Chinese investors build infrastructure in the Ord River (which suffers from poor transport and a lack of scale), in return for land and water rights.

[60] A Commonwealth Government report noted 'Foreign investment in Australian agribusiness, as with foreign investment in other sectors, has increased the supply of capital in the economy. Higher investment has led to greater production, employment and income. The foreign companies engaged in agribusiness activities have typically financed expansion in productive capacity or restructuring in an industry to improve efficiency and viability.' B. Moir, *Foreign investment and Australian agriculture*, Rural Industries Research and Development Corporation, November 2011.

[61] For example, the reactions to the sale of Cubbie station: Labor sells off the farm to China, *Daily Telegraph*, 1 September 2012.

[62]Six per cent figure is derived from ABS Catalogue 7127.0, *Agricultural land and water ownership survey*, December 2010, Table 5. This figure is little changed since 1984. Nevertheless, because of the imperfections of this survey, the Government has commissioned a land register of foreign interests. Export figure is from *Global food security: facts, issues and implications*, Science and economic insights, Australian Bureau of Agricultural and Resource Economics and Sciences, Issue 1-2011.

Conclusion

The Australian Government will soon release its White Paper on the 'Asian Century'.[63] Amongst other things, this will provide a great opportunity for a wide-ranging response to the problems and opportunities in the bilateral Australia-China investment relationship. At a minimum, the Government's response should ensure a more consistent welcome message to China (and indeed other Asian countries) about investment, and stronger mechanisms to proactively explain government investment policy and decisions. Ideally, the Government's response should include initiatives for investment cooperation with China, including in the areas suggested above.

Looking at the data alone, the flow of Chinese investment to Australia in recent years suggests a very strong relationship. But Australia's ranking is slipping, especially relative to other resource-rich countries, such as Brazil and Canada. There are a range of reasons why this is the case but it is in Australia's national interest to ensure that perceptions of mistrust, discrimination and misunderstanding are not amongst them. China is a major new supplier of global capital, with massive potential for further increases. Australia looks set to remain a capital importer for some time. Australia is an attractive investment destination for China, especially given its complementary economic structure and stability. Improving the bilateral investment relationship is commercially beneficial for both countries. Going beyond the commercial, it is particularly important that tensions in the investment relationship do not infect the overall bilateral relationship. Given the significant political and other differences between Australia and China, different perspectives on a range of global, regional and bilateral issues are inevitable. However, properly managed, the investment relationship should be a source of strength and contribute to the economic prosperity of both countries.

[63] White Paper on Australia in the Asian Century, announced by the Prime Minister, 28 September 2011. The Paper will consider, amongst other things, opportunities for a significant deepening in our engagement with Asia.

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