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Making Sense of China Today

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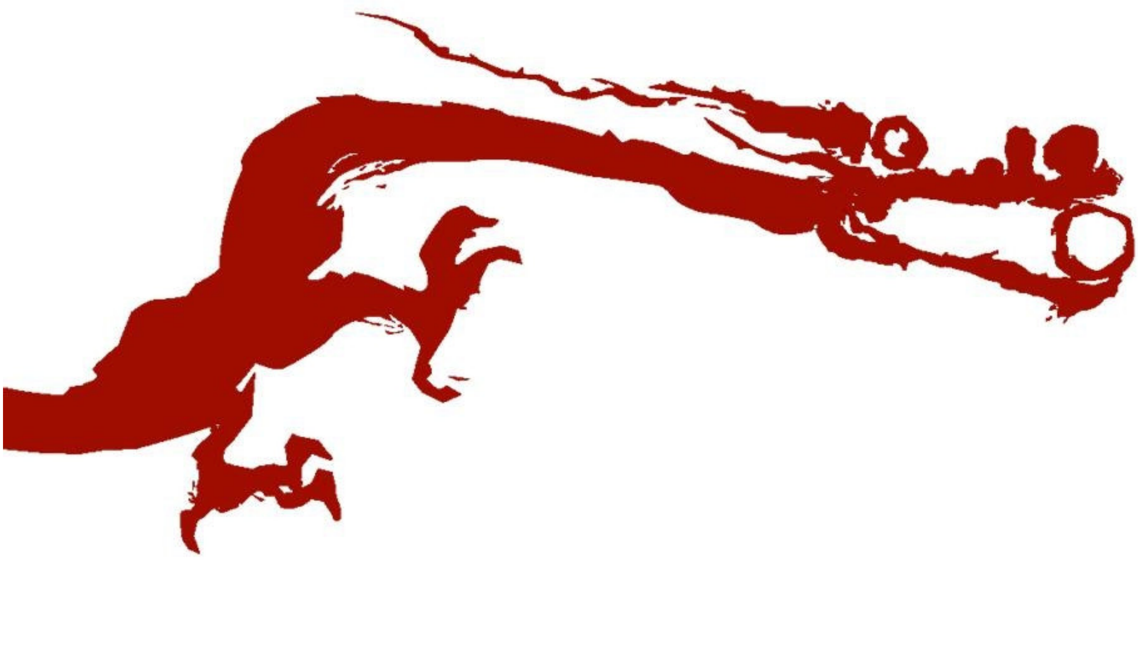

1. Introduction

Travelling in the Zhejiang Province outside Shanghai in mid 2008 after the Rudd Government came into office, when I talked to Chinese enterprises about Australian investment, I was quite taken that even in small townships everyone knew of the Australian Prime Minister Kevin Rudd and his Chinese name Lu Kewen, and that he spoke fluent Chinese.

Everyone seemed to know that he was the only foreign leader who could speak Chinese.

Contrast that with the deterioration of our relationships with China in Australia over much of this year and the stresses between China and Australia over a range of events, some the doing of the Australian Government.

The paradox is that the relationships between the Australian and Chinese Governments have experienced considerable tensions over the past year, while on the economic front business activity between China and Australia has never been better.

Serious tensions arose following the collapse of the state-owned Chinalco bid for Rio Tinto early this year. There was considerable resentment at high levels in the Chinese Government over China's failure on that deal and the behaviour of Rio Tinto on the bid.

There have also been tensions over the Australian Government's Defence White Paper which targeted China, the visit to Australia by the Uighur Rebyra Kadeer and Jeff Daniel's film documentary, and the detention of Rio Tinto's Executive Stern Hu.

Also the proposed Rio Tinto BHP merger is worrying the Chinese steel industry and BHP's recent counter bid for United Minerals to defeat China Rail's previous bid.

Considerable efforts have been made between both sides in recent times to try and repair the relationship, and it has been much improved but there are still hurdles to overcome to return to the better times.

2. FIRB Issues

A sensitive area of tension between the Rudd Government and China is over Australian foreign investment policies. Whenever I go to China, I regularly get asked whether Australia really wants to have Chinese investment. This is a widely held concern. It is without question the single most significant source of tension between China and Australia.

There have been a number of cases where problems have arisen for Chinese foreign investment proposals in Australia.

The two most commonly cited cases are the failure of Chinalco to acquire its increased equity in Rio Tinto this year. The other is more surprising. It was the failure of the Chinese supported syndicate to win the competitive bid for the $4 billion Oakajee Port & Rail project in Western Australia which was won by Japanese-backed interests. We have since been appointed on this project to bring in Chinese participation.

This was after the Chinese President Hu Jing Tao had expressed support for the Chinese bid when he visited Perth in September 2008. There was some loss of face over this.

Since the Rudd Government came to office in 2007, the volumes of foreign investment applications have accelerated and Chinese enterprises have pursued numerous and widespread investments in the Australian minerals and energy fields.

Australia and Australians have been major beneficiaries of Chinese investment and Australia have avoided much of the impact of the Global Financial Crisis with the injection of massive Chinese investment into our resources sector.

But from the Chinese viewpoint, the story has been very mixed and the Chinese are often confused as to decisions taken by the Australian Government regarding their investment proposals.

At the beginning of 2008, the Foreign Investment Review Board, which is the administrative body set up to review foreign investment applications, approved the 100% takeover of Mid West by Sinosteel. That proved to be an aberration best explained by its timing before the Rudd Government settled into office in Canberra.

Around that time, Chinalco had also made a bid for 12% of Rio Tinto in London which was equivalent to 9% of the Australian arm of Rio Tinto, without seeking Australian foreign investment approval. That was later remedied but the approval was only granted six months later.

In February 2008, the Australian Treasurer Wayne Swan published a set of principles which he said would guide the Government's decisions on foreign investments in Australia, and especially those of Sovereign Wealth Funds and Foreign Government Controlled Entities, which of course included all of Chinese State-Owned Enterprises.

However, much confusion and certainty have prevailed. Foreign investment applications were often delayed, often for long periods of time, or were warned off or had conditions imposed which were unacceptable. Some takeover proposals were capped at 49.9% equity notwithstanding Sinosteel's Mid West approval in January.

At a speech at the ACBC Foreign Investment Conference in Melbourne on 4 July 2008, Treasurer Swan added another twist when he announced that the Government would look more closely at foreign investment proposals for projects where the Chinese investors were to be the customers for the mine production.

In 2009, Chinalco announced the further bid for Rio Tinto to go to 19% with direct acquisitions into Rio Tinto's iron ore and bauxite operations detailed in a 600 page agreement.

While the bid ultimately failed when the Rio Tinto board withdrew from the deal, the Australian Government has been left with the allegation that its delayed FIRB review had seriously impeded the bid to cause its failure.

Further uncertainty followed with the speech by Patrick Colmer, the Executive Director of the FIRB at another ACBC Conference in Sydney in September. He announced that the Australian Government would prefer partnership arrangements involving a maximum 15% stake in major projects and a maximum 50% stake in new green fields projects.

Interestingly, these indicative ownership levels have never confirmed by the Australian Treasurer.

However, on 3 November in China Michael Murphy the Deputy Secretary of the Treasury warned that the FIRB will subject Chinese companies to particular scrutiny if they plan to invest in resources companies in which they are potential customers and if the proposed ownership increases potential control over pricing and products.

Mr Murphy also confirmed that Mr Colmer's previous comments about preferred limits for foreign Government owned investments amounted to official government guidelines.

Mr Murphy nevertheless endeavoured to assure Chinese investors that Australia welcomed their investment in Australia. He said, "Since the Rudd Government came to power in November 2007 it has approved some 110 Chinese investment applications with a total value of over $39 billion". He added that, "Not one business application has been formally rejected by the FIRB".
Mr Murphy failed to explain why recent FIRB decisions have contradicted Mr Colmer's guidelines.

We have noticed a major change of heart on the part the Australian Government in recent weeks, especially following the speech in Canberra by the Australian Foreign Minister Stephen Smith in October.

Most recently, the FIRB has approved two Chinese takeovers of Australian companies, one a full 100% takeover and the other 70%. These are significant in the face of previous FIRB rejections of Chinese takeovers in the past.

The latest approval came just one day after a speech by BHP's Chairman Don Argus calling for greater debate on foreign investment in Australian resources with fears that Australia could follow the Canadian experience where the resources industry "hollowed out" with most of Canadian resources now being controlled by foreign companies.

The rate of Rudd Government approvals for Chinese investment in the resources sector has dramatically accelerated. In the past four weeks, four major Chinese investments have been approved. This comes after three months when decisions almost stopped just after the 5 July detention in Shanghai of Rio Tinto's Executive Stern Hu and three other Rio Tinto employees.

By comparison, when Japanese investment took off in the 1960's and 1970's the Australian Government had first introduced foreign investment controls in response to public concerns.

However, the Japanese investment was different. The Japanese basically focused on major projects where they seek small strategic holdings and they did not seek to takeover Australian companies or acquire majority ownership.

Nevertheless, the fears about Chinese investment appear to be overblown.

In fact, despite the FIRB's figure of $39 billion of approvals, according to Austrade actual investments are only around $6 billion.

The Reserve Bank said a week ago that at the end of 2009, Chinese entities owned about $8 billion worth of assets in Australia, which is less than one half of 1% of the total foreign investment in Australia.

3. Iron Ore Trade

The second area of tension between the Australian and Chinese Governments is over the iron ore pricing negotiations.

Just to put the iron ore trade in a real context, Australia currently supplies more than 40% of China's iron ore imports.

Rio Tinto announced this week that over the next five years, China is expected to import more Australian iron ore than all of the iron ore shipped to China since exports first commenced in the 1960s.

The wealth creation for Australia is and will continue to be enormous.

Traditionally, iron ore prices are set by direct negotiations between the three big iron ore producers, which include Rio Tinto and BHP in Australia and Vale in Brazil, and the Steel Mills in Japan or China.

This year, the Chinese Government's China Iron & Steel Association took control of the negotiations from the Chinese side. A lot is at stake for Australia as iron ore has over time been the major source of exports and therefore foreign currency earnings for Australia.

What happened was the Japanese Steel Mills once again set the benchmark prices following the failure of the Chinese to act and while no benchmark prices were agreed between China and Australia, Rio Tinto and BHP have been selling at provisional prices based on the Japanese Steel Mill prices in the absence of any agreement with the Chinese.

The role of CISA was seen as a move by Chinese hardliners to step in to take away from the steel mill industry their role and that has had other implications inside China.

It is difficult to dismiss the Stern Hu affair from all of this.

I had been at lunch with Stern Hu two weeks before his arrest along with that of the three other Rio Tinto staff in Shanghai. This has become a very serious matter. Stern was arrested and charged with theft of national secrets and espionage which amounted to very serious charges. They have since been downgraded to that of theft of commercial secrets and bribery, with some resulting loss of face on the part of the prosecuting authorities in China.

The Stern Hu affair raised serious questions about Australia's consular agreements especially with China. It is difficult to see that arrangements can be acceptable and satisfactory when no consular access was available for one week after his arrest and is only permitted on a monthly basis.

It is interesting that Mr Rudd has not met with the Chinese President over this but the best take is that the Chinese have refused such a meeting.

Trade Minister Simon Crean went to China to meet his counterpart, but the Chinese Minister of Commerce, the Vice Minister of Commerce and the Director of the Ministry of Commerce all refused to meet him and he ended up meeting with a fourth level official.

Clearly our relationship with China had reached a low point at that time.

In a planned effort to turn things around, in October the Australian Foreign Minister Stephen Smith announced he was to give a key note address in Canberra and I was invited to travel to Canberra for a speech which was scheduled to take 20 minutes.

In his speech he endeavoured to defend the Australian Government's record on dealing with China but generally speaking the speech was something of disappointment.

A very significant turning point was the visit to Australia two weeks ago by the Vice Premier of China Li Ke Qiang and the fact that he made the visit at all. Mr Li who is a member of the Chinese Politburo is widely predicted to become the next Premier of China.

Mr Li gave an excellent speech in Sydney which covered a lot of areas but above all else, he opened the door to greatly improve relations with Australia.

4. Chinese Government Milestones

Over the past year China itself has experienced a number of important milestones.

2008 represented 30 years since Deng Xiaoping first introduced China's Open Door Policy which opened China to the outside world.

China also hosted the brilliantly successful Beijing Olympic Games in August 2008 which did much to announce China's rise as a world power.

On October 1 this year, the Chinese Communist Party celebrated the 60th Anniversary of Communist rule in China with the rise of Mao.

The Party has been transformed over those 60 years from the effective dictatorship of Mao Zedong as the founder of the Communist Party to the present time with the more collegial, team oriented and collective leadership which has developed since Jiang Zemin.

The new leadership team is well aware of the need to maintain stability in the face of enormous socio-economic change.

The simple fact of the Party today is that every leader since Mao has wielded less and less individual power and has been forced to seek consensus on important decisions.

5. China's Open Door Policy in 1978

In terms of its significance to recent Chinese history the most important development must surely be the decision in December 1978 by Deng Xiaoping to introduce the Open Door Policy.

At that time, China had just seen the end of the culture revolution in 1976 which had so devastated China. China had no legal system to deal with this. When I first went to China in 1981 and was invited to become an adviser to the State Council's Economic Law Centre to help draft China's joint venture laws, China had one five page document in which to base foreign investment.

It is easy to gloss over what an extraordinary story it has been.

In an interview in September 2008, Chinese Premier Weng Jiabao stated, "We had one important thought when we opened up the economy 30 years ago and this was that socialism can practice a market economy". He went on to justify China's version of semi-market capitalism as "socialism with Chinese characteristics".

The hundreds of millions of Chinese lifted out of poverty as a result of Deng's reforms will mean in time that he will come to be regarded as a greater hero than Chairman Mao.

Peter Jay in his book, The Wealth of Man described the emergence of China as the most sustained period of wealth creation in history, with a 68% fold increase since 1978.

China has been able to use the 30 year achievement of globalisation that increased cross border trade to spark rapid economic advancement in much the same way as previously done by the Tiger economies of Asia and early Japan.

China is rapidly becoming the world's factory and Chinese production has also now become a magnet of the world's multi-national companies.

6. China's "Going Global" Policy

The second leg of China's economic modernisation after Deng Xiaoping's 'Open Door Policy' is China's Going Global Policy initiated by Chinese Premier Zhu Rongji around 2002.

In July 2009, Chinese Premier Weng Jiabao said, "We should hasten the implementation of our going out strategy and combine China's utilisation of foreign exchange resources with the going out of our enterprises".

Chinese foreign currency reserves have now reached $2.25 trillion, much of that the result of massive trade imbalances with the United States. Just under $1 trillion of that is invested in US bonds with the balance being available for Chinese overseas investment.

China is encouraging its enterprises to go out to countries like Australia to pursue strategic investments, especially in energy and resources.

We can read about the impact on the Australian economy everyday in our financial press. We are living in unprecedented times of economic prosperity based on China's demand for our natural resources while much of the rest of the world is still caught by the Global Financial Crisis.

While Australia is benefiting enormously from Chinese investment, Australia is not the only major destination for Chinese overseas money and ongoing concerns whether Chinese investment is welcome in Australia is a serious concern.

Chinese investment in Africa is already considerably ahead of that in Australia. China is also focussing on Brazil, Russia and other countries as targets for its foreign investments.

Two way trade between China and Africa ballooned to more than $106 billion in 2008 which is roughly double that between Australia and China.

China is also offering $10 billion over the next three years as concessional loans to African countries.

7. The Environment and China's Response

Let me now talk briefly about two key areas of China and their importance as a developing world power.

Environmentally, the challenges facing China are huge.

China has been replicating the UK's total electricity capacity each year and will need to do so at least until 2020 when its generating capacity will be effectively trebled.

In 2008 China had already become the largest source of Co2 emissions and the current projection is that by 2030 China will be responsible for 33% of global emissions.

China's dilemma is how to enrich the people without also ruining the economy and, because of China's size and scale, the environment of that of its neighbours and the world as well.

An official Chinese report in 2008 admitted that more than 70% of the country's rivers and lakes are polluted, and the ground water in 90% of Chinese cities is tainted.

Most observers expect to see China emerge as a global leader in green energy technology. It is already poised to lead world production in solar cells, wind power turbines and other low carbon energy technologies.

Yesterday we saw the dialogue between Premier Hu Jintao and President Obama in Beijing on the prospects at the Copenhagen Environment Conference.

8. China's Science and Energy Developments

About five years ago a considered move was undertaken at the highest levels of the Chinese Government to begin building greater scientific capability and to attract resources back from overseas into key major technology areas.

China's 11th five year plan made the next stage even clearer. The term "scientific development" is political code for increased industrial economic development, moving China from the world's factory to an economy grounded on technology, innovation and increasingly, science.

Technology transfer and know how are extending China's reach internationally and are seen as the key currencies of the country's reputation and influence into the future.

China's growing influence in cutting edge fields such as renewable energy, electricity and bio-technology are evidence that the state coordinated push into research and development is starting to bear fruit.

China has come a long way in 60 years and in no field is this more than evident than in science.

Before the rise of Europe in the 16th Century, China led the world in science and was responsible for many inventions.

The Chinese Government is determined to put China back at the forefront of science.

9. A Contextual Background

A key to better understanding China today must be to recognise the many humiliations it has suffered – both self inflicted and externally imposed since the mid 1840s.

The opium wars, imperial colonisation, the 1849 Treaty of Nanjing over Hong Kong, the fall of the Qing Dynasty, the Japanese invasion, the Cultural Revolution etc.

The focus on social stability and rebuilt national pride have been attributed to these events.

China's youth have largely grown up in an era of high growth and increasing consumption. They are clearly proud of China's economic progress and its rising international standing. There has been a clear resurgence of nationalism in recent years.

With Marxism no longer able to provide an adequate explanation for the market oriented economic policy, the Communist Party has increasingly turned to nationalism and the promotion of traditional Chinese culture as alternative sources of legitimacy.

10. Conclusion

China's economic development and opening up to the outside world have given its people unprecedented personal freedom.

The reality of China's political power structure, the desired focus on social stability and national pride in the "rise of China" all suggest that there should emerge a Middle Kingdom once again.

With attribution to my friend Rowan Callick in the Australian, the following may best summarise China over the past 60 years.

1949 – The Communist takeover China

Only socialism can save China.

1979 – Deng Xiaoping's open door policy

Only capitalism can save China.

1989 – The collapse of the Soviet Union

Only China can now save socialism.

2009 – The Global Financial Crisis

Only China can now save capitalism.

Think about it.