Negotiators held in ore

China has cast surprise doubt on Australia's economic growth, at least for now, with a tough stance on iron ore prices. China correspondent **Rowan Callick** reports

THE annual poker-style international negotiations on the price for iron ore have emerged as the biggest single event on the Australian economic calendar. Last year, Australia gained a 2 per cent rise in the entire national income out of the rises its producers won for its biggest two exports, iron ore and coal, chiefly because of the surge in demand from booming China.

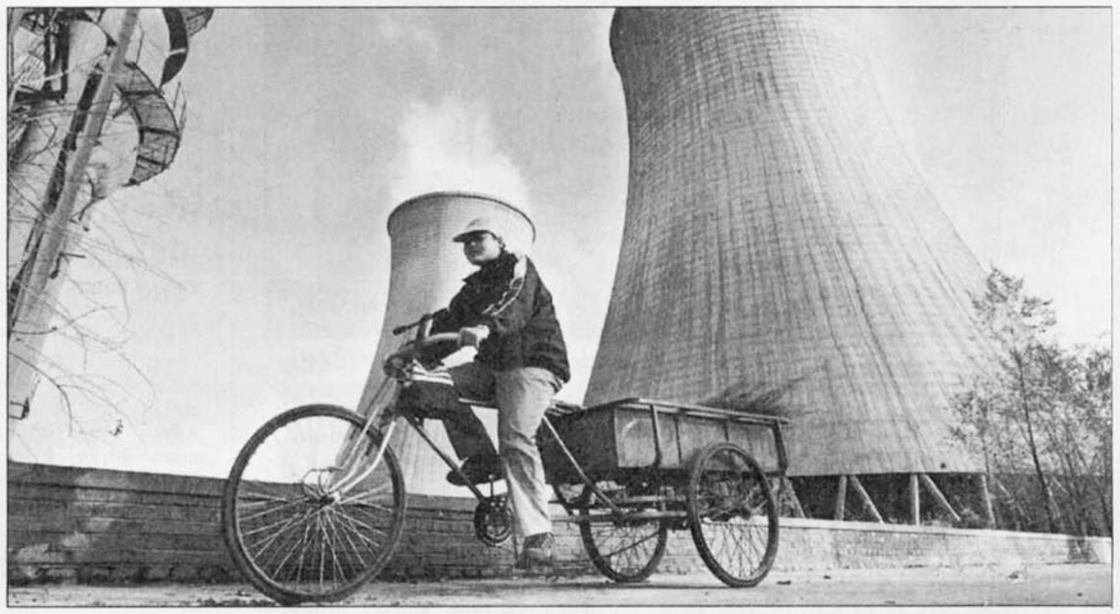
This year, China is understood to be desperately trying to hold down prices by banning the import of any ore above a price set by its Ministry of Commerce, said to be the average price of 2005. Ships have been turned back as a result and the row will take centre-stage at talks in Canberra in early April between Prime Minister John Howard and his Chinese counterpart, Wen Jiabao.

"This is a watershed in the negotiations. The game has moved on to a new level," says Ray Chantry, resources analyst with broker E.L.&C. Baillieu in Melbourne.

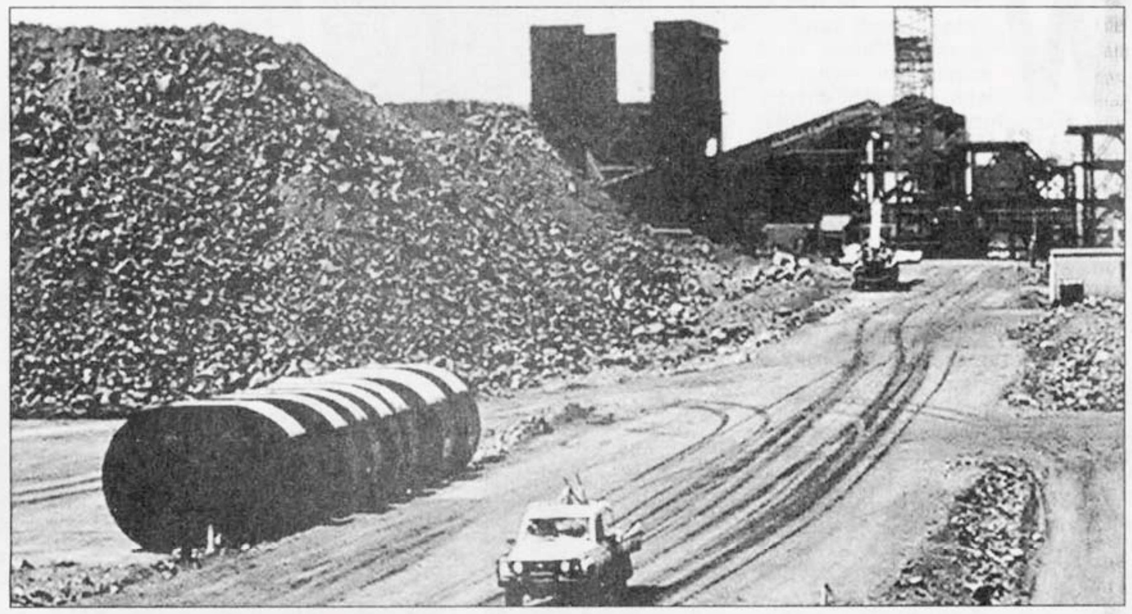
It's some game. The resurgence in Australia's wealth in the past few years, largely on this trade, mirrors the country's first great vault to prosperity on the sheep's back and on the glitter of gold, commodities whose prices soared as Britain industrialised and boomed.

And it's a game that's being played hard. The routine political and business rhetoric asserts that the economies of Australia and China are complementary. But that only applies to the countries' needs, not to their different understandings of how the global economy works or should work. China's single-party government retains ultimate control of all the country's strategic industries, with steel at the centre, and is extending its influence as it enforces consolidation of steel production by shutting many smaller mills, built in the past few years by opportunistic private developers when ore prices were low and steel prices high.

Canberra intruded in the negotiations for the first liquefied natural gas contract to China, worth $25 billion, to ensure Australia won, but urged on the private partners such a low price that China has failed to gain any more deals in the three years since; marketer North West Shelf Australia LNG agreed on a deal on Wednesday to sell up to 1.4 million tonnes of gas a year to Japanese utility Chugoku Electric Power Company. The Australian Government also has prevented the sale of strategic companies such as Woodside. But it has resisted taking the front-running in most other business deals with China, including the crucial iron ore talks — so far.



Full steam ahead: The giant Shougang iron and steel mill on the outskirts of Beijing



Groundwork: BHP Billiton's Newman mine at Pilbara in Western Australia

At the heart of the relationship with China, there remains a clash of world views that rivals the much vaunted complementarity: the five-year plan against the market, a clash coming to the fore in the tensions of recent days since China began imposing its new price cap.

Ross Garnaut was the architect of Australia's economic opening under Bob Hawke two decades ago, then became ambassador to China and is now an economics professor at the Australian National University. He says China's response to the price hikes does not comprise a return to the old command economy, more a reaction to what it views as the locking up of two-thirds of supply by a virtual cartel and to the shift of market power to those suppliers.

Although China may yearn for greater co-ordination among importers, that's unlikely to happen in the near future, especially with relations with Japan so strained, as well as those between Japan and South Korea, whose Posco is a leading steel producer.

"Australia doesn't yet have the grip on China's ore market that it used to have on those of its Asian neighbours," Garnaut says. "But it has an opportunity to lift its role, especially since Chinese steel mills pay significantly less for Australian ore under long-term contracts than for contracted ore from Brazil or for ore sold under spot market terms from India."

Last year the average price for Australian ore landed in China was $US55 ($74) per tonne, compared with $US67 for all international ore. Government commodities forecaster the Australian Bureau of Agricultural and Resource Economics predicts local export income from iron ore will rise about 26 per cent to more than $18 billion in the 2006-07 financial year.

A year ago, the larger members of the big three ore producers — fellow Australian Rio Tinto and Brazilian giant CVRD — settled at a 71.5 per cent hike. But the third, BHP Billiton, held out, seeking to gain a higher rate for Australian ore because of this gap, due to the lower freight cost.

But it failed after a two-month campaign during which the company was widely vilified as greedy by Chinese officials. Ambassador to Australia Fu Ying told a packed Melbourne Mining Club audience in December: "The [2005] price rise has become such a painful experience that China is very nervous about depending on certain countries and certain mines." Meaning, the audience presumed, Australia and its iron ore mines.

Some smaller Chinese companies have gone bankrupt, she said: "They can't sustain such damage", although the ore rise only comprised about 4 per cent of the overall cost increases of the Chinese steel industry.

Fu also warned that the iron ore increase could result in a backlash over buying uranium from the same sources, despite BHP's Olympic Dam in South Australia containing one-third of world reserves, emerging as the equivalent to uranium of Saudi Arabia to the oil industry.

BHP's Texan chief executive Chip Goodyear says that, today, gaining a bigger rise for Australian ore "is not something that we are going to die in a ditch over". Especially when his company's sales of all products to China in the first half of this financial year, to December 31, totalled almost $6 billion. Nevertheless, he says, "we continue to educate the Government on these issues". But BHP demonstrated last year that it tends to be better at digging up resources than at explaining itself.

Its best tool has become the market metaphor. If two stalls sell tomatoes of the same size and quality, will the buyer bother checking which came from the closer farm? It's the bottom line that will count. And BHP wasn't even seeking the same price but a midpoint between the landed prices for ores from Australia and Brazil. This would have realised an extra $2 billion revenue for Australia.

It was only when Japan began industrialising at breakneck pace in the third quarter of the 20th century that most of Australia's minerals gained a genuine global value, with the rising value of metals spurring the design and construction of new fleets of big, cost-effective carriers, matched by new mills alongside deep water ports. Previously, the expense of transporting all but gold had exceeded the likely returns.

The rapid growth of smaller Asian economies such as South Korea and Taiwan kept this market buzzing until demand began to slow in the 1990s, before China picked up the baton and became the new engine of growth for virtually every leading commodity.

"Since the end of the housing boom three years ago, virtually all the growth of the Australian economy has been driven, directly or indirectly, by the China-related resources boom," Garnaut says.

But despite the surge in sales to China, the Australian share of the iron ore market has fallen in recent years. This is because when there was plenty of spare ore and the spot price was lower than the longer-term contracted price that Australian producers have mainly used, the growing Chinese mills bought more on the spot market, substantially from India. Today, that situation is reversed. Spot prices are high and contracts, especially with Australia, can help keep costs down.

But analysts such as Chantry say the possible effects of China's attempt to stem any increase in the contract price will include the big three suppliers selling more of the ore at costly spot prices and signing more contracts with China's neighbours and European buyers accustomed to living with market swings.

"As confidence develops between China and Australia, trade can grow and grow and grow without continued political nurturing," Garnaut says. But that day appears more distant now, with Australian politicians, led by Trade Minister Mark Vaile, being dragged into the fringe of iron ore price negotiations via China's import cap.

This will be viewed as an early success for its brash initiative by Beijing, which retains control of its economy through its 169 core state corporations and remains far more comfortable dealing with fellow governments.

It's not that Australia's politicians don't also have a direct interest; governments stand to gain about half of any ore price increase. But that interest is, in this case, the opposite of their Chinese counterparts.

And Japanese and South Korean mills are today reporting strong profits, while many Chinese mills are not. Whatever Beijing's concerns about costs, however — and China's leaders have always feared the instability created by inflation — the requirement to keep fuelling rapid growth is paramount.

Wen, opening China's annual parliament session last Sunday, said the Government expected an 8 per cent rise in 2006, fulfilling the core, unwritten contract between the Communist Party and the population: the party ensures constantly rising living standards, the people leave the party to run the show its way. This means China's steel mills — which depend on imports for half of their iron inputs, chiefly of the higher grade ores (with more metal inside the rock) required by their newer plants — must keep buying more from overseas. They have rocketed into the world's top buyers.

Total imports last year were 273 million tonnes and this year the mills are expected to need another 40 million to 50 million tonnes, despite the tight global supply situation.

No wonder Melbourne-based lawyer Robin Chambers, who represents the Australian interests of some of China's biggest resource and industrial companies, is constantly trawling for new mines in which his clients can participate, though the scope is limited because the dominant players, Rio and BHP, are reluctant to take on more joint-venture partners. In the past, says Chambers, they and Brazilian CVRD, which together control two-thirds of the global trade (BHP about 14 per cent, Rio 21 per cent, CVRD 31 per cent), have "been very careful not to let the buyers play them off".

But having sniffed that prospect last year with BHP going it alone for a couple of months, vainly seeking an extra rise, it would not be surprising to see the Chinese importers trying to entice one of the three to seek a bigger guaranteed market share in return for accepting a lower price.

The 16 leading Chinese mills are being represented by the biggest of them, Shanghai-based Baosteel. Its formidable chairwoman, Xie Qihua, is a leading player in the tangled web of institutional Chinese politics in which the Commerce Ministry, the China Iron and Steel Confederation, the Chamber of Commerce for Metals and Chemicals Importers and Exporters, and the National Development and Reform Commission — the macro-economic regulatory agency of the State Council or cabinet — are all seeking to raise their influence and gain kudos from somehow taming the inconvenient global markets.

China's play may succeed in bringing closer the end of the strange, ritualistic structure of the annual talks. Most other commodities are priced by the minute on exchanges, rather than by the iron ore and coal process.

This has buyers and sellers meeting, as now, to pass over to each other their analytical papers explaining why supply or demand will be constrained, depending on which side they are on, until numbers, floated through the media or at industry conferences, come close enough for talks to start in earnest.

The buyers are permitted to collude, the sellers not; if they do, it's branded a cartel, hotly denied in the case of iron ore, even though all tend to accept a price once struck. When a credibly big buyer agrees on a price with a credibly big seller, the endgame is usually near. But this year, the Chinese have thrown a spanner in these works and none of the players is quite sure what will happen next.

In traditional economics, such uncertainty favours those with the tightest market profile; this year, it's the sellers, chiefly the Australians and Brazilians. But business cycles can spin around and structuring incomes to reflect such fluctuations is a crucial element of the industry because of the huge investment needed to bring new mines on stream and transport the ore long distances.

Industry insiders say the Chinese are still learning this game. But negotiation sessions with them are livelier and likelier to embrace some humour than those with the Japanese, where long silences are a feature. And few are betting against the Chinese learning fast or, ultimately, winning.