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ANALYSIS

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## INTO THE DRAGON'S DEN: AUSTRALIAN INVESTMENT INTO CHINA

### EXECUTIVE SUMMARY

*During the controversy over Chinalco's bid for Rio Tinto, there was a heated debate regarding Australia's treatment of foreign investment in general and of Chinese investment in particular. While the main focus of the debate was on actual and perceived barriers to Chinese investment, it also opened up a discussion about the treatment of Australian investment in China. This paper reviews Australian foreign direct investment (FDI) into China and the related policy implications.*

*The paper makes several key judgments about the bilateral investment relationship, including: that China will continue to open up to foreign investment in a manner that best suits China's domestic political agenda; that there are significant perception gaps on key issues between China and foreign investors; that Australia should neither overestimate nor underestimate its strategic importance to China; that there should be very limited expectations about the Australia-China Free Trade Agreement, especially if reciprocity is a key condition; that, even with a significant easing of formal investment barriers to China, Australian FDI is unlikely to be substantially higher; and that Australia needs to ensure that the openness and transparency that we desire from China is also apparent in the way we deal with China, including in the approval process for Chinese investment in Australia.*

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### Introduction and summary

China is now our largest trading partner, and the Chinese economy a key driver of Australia's economic performance. At times, that trading relationship can be overshadowed by sensitivities surrounding Chinese investment in Australia.<sup>1</sup> There has been relatively little attention on Australia's foreign direct investment (FDI)<sup>2</sup> into China, which is only a minor part of the Australia-China economic relationship.

Like other countries, Australia faces considerable formal barriers to FDI into China. These barriers are more significant than the barriers to Chinese FDI into Australia. Despite this, Australian investment in China has continued to grow, albeit from a low base.

Moreover, even if China were to remove all *formal* investment barriers, it is not clear that Australian FDI into China would be significantly greater because of the *informal* barriers and the apparent preference of Australian investors for economies with similar cultural, political and institutional frameworks.

Foreign business groups operating in China believe that China's FDI regime is now less welcoming. Despite this, business surveys indicate that foreign companies intend to continue to expand in China and are generally profitable.

From the Chinese perspective, foreigners are now facing more intense Chinese competition and an earlier bias towards foreigners has been removed. Further, China no longer needs foreign capital. There is a Chinese view that, despite all the complaints, *foreigners will come anyway*.

In looking at the experiences of Australian investors in China, this paper draws on published material as well as confidential interviews, conducted for this paper in Australia and China, with Australian companies investing in a range of Chinese industries and with business facilitators. A Chinese perspective (official and unofficial) was also sought on foreign investment into China and related policy issues.

The paper is in four parts. Part One reviews the Australia-China bilateral economic relationship, including the role of two-way FDI flows. Part Two focuses on Australian FDI to China and what drives these flows. Part Three outlines China's inward FDI policies and other barriers to investment in China. An assessment is provided, based on foreign investors' experiences. The possible role of a successful Australia-China Free Trade Agreement (FTA) in removing some of those barriers is also covered. Finally, Part Four draws out some policy considerations.

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### Part One: The Australian-China bilateral relationship

#### China's rising economic power

The background to the debate on the Australia-China investment relationship is, of course, provided by China's economic rise. With an average of almost 10% annual economic growth over the last 30 years, China's economy is now the second largest in the world.<sup>3</sup> On some projections, China will overtake the US by 2032.<sup>4</sup>

While China's recent growth is remarkable, this can also be interpreted as China returning to its more 'natural' global economic status, particularly given its share of world population.

Publicly, the Australian government is quite comfortable with this development:

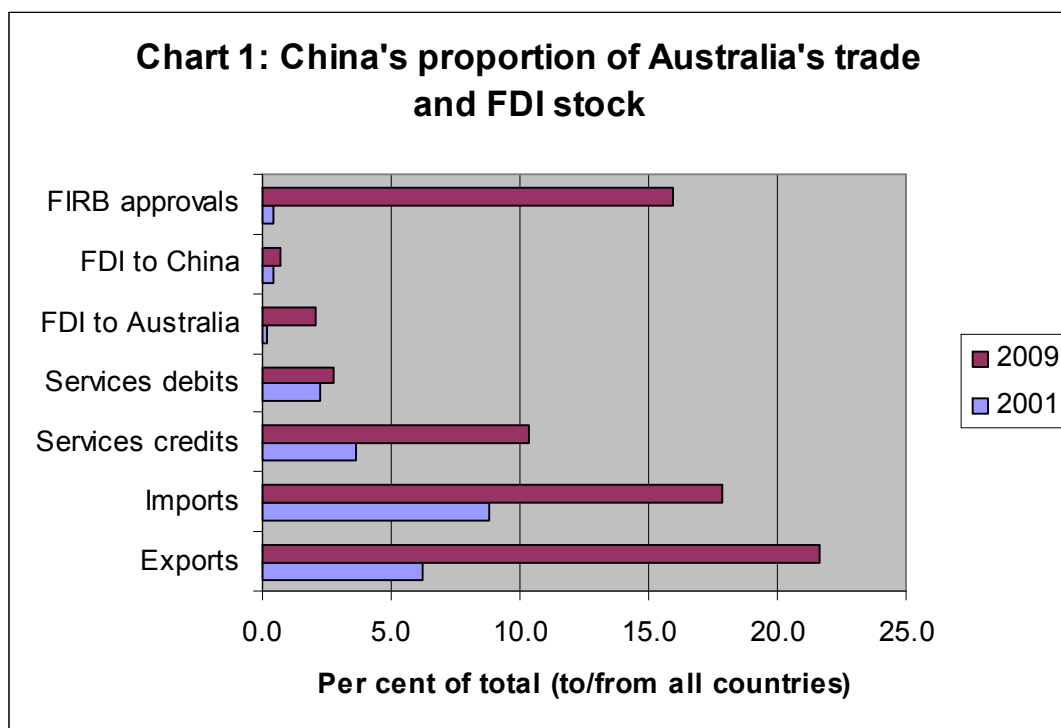
*"Australia fully welcomes China's return to its historical status as a major economic power. Australians are comfortable with this reality, understanding that as China grows, so does Australia".<sup>5</sup>*

Further, Australians appear to be positive about China's economic growth, with a recent Lowy Institute poll reporting 73% of respondents agreeing with the statement that "China's growth has been good for Australia".<sup>6</sup>

#### The Australia-China economic relationship

One consequence of China's economic rise is that Australia's economy is growing increasingly dependent on China. China is now Australia's largest trading partner – representing 20% of trade in 2009. China's share of total Australian merchandise trade (goods), services trade (such as travel and education) and FDI inward stock has increased significantly in recent years (Chart 1).<sup>7</sup> Foreign Investment Review Board (FIRB) approvals – a forward indicator of FDI inflows – show that trend continuing.

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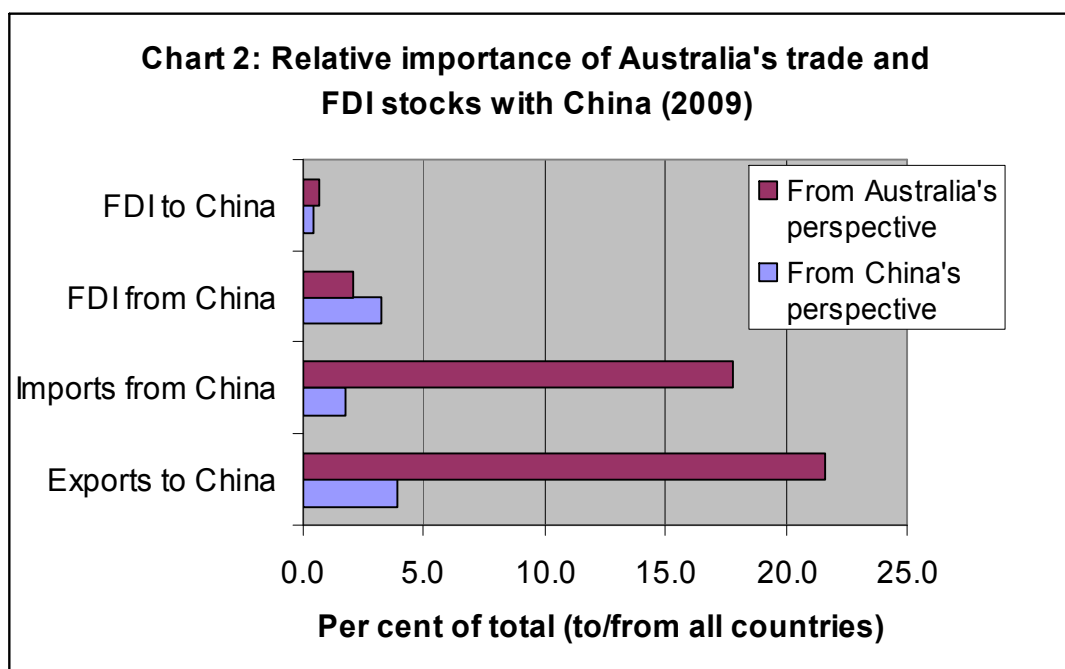


Source: *International investment position, Australia: supplementary statistics, calendar year 2009*, ABS Cat. no. 5352.0. Canberra, 2010; *International trade in goods and services*, ABS Cat. no. 5368.0. Canberra, 2010; *International trade in services, 2009*, ABS Cat. no. 5368.0.055.004. Canberra, 2010; *Foreign Investment Review Board, Annual Reports, 2000-01 and 2008-09*. All data are for calendar years, except FIRB approvals which are for the financial year. 2000-01 FIRB approvals for China are not published but are understood to be around 0.5% of the total value of approvals.

While merchandise trade has traditionally dominated Australia's economic relationship with China, service trade and investment *into* Australia are assuming greater importance.

Looking at trade and investment *in aggregate*, China's economic importance to Australia appears greater than Australia's importance to China (Chart 2). For example, Australian exports to China in 2009 were more than 20% of total Australian exports. But from China's perspective, imports from Australia were only 4% of China's total imports.

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Sources: ABS *International trade in goods and services*, Cat. No. 5368.0. Canberra, 2010; ABS *International investment position, Australia: supplementary statistics, calendar year 2009*, Cat. no. 5352.0. Canberra, 2010; Invest in China website: *Brief on China's Import and Export (2009/12)*. The "From China's perspective" FDI stock data is calculated from ABS Cat. no. 5352.0 and from UNCTAD, *World Investment Report 2010*, July 2010. Note, there can be significant differences in Australian trade and investment data. See *Australia-China Free Trade Agreement: joint feasibility study*, 2005, Annex 2.

From China's perspective, Australia is outside China's top ten export destinations and is China's seventh largest import supplier.<sup>8</sup> Australia's 4% import share is driven substantially by Australia's key role in supplying iron ore. In 2009, Australia supplied 40% of China's iron ore imports.<sup>9</sup> Accordingly, the aggregate data could understate Australia's strategic importance to China.

Meanwhile, *Chinese FDI into Australia* is assuming greater importance for both countries.

China's increasing FDI footprint reflects its rising international foreign exchange reserves and a more explicit policy to 'go global', including for ensuring security of resource supply. China was the 6<sup>th</sup> largest source of global FDI outflows in 2009.

As in other countries, this FDI from China has raised Australian concerns, including because of the perceived risk of non-commercial activities by investors that are state-owned enterprises (SOEs).

FIRB approvals indicate continued strong growth for Chinese FDI flows into Australia, with investment heavily concentrated in the mining sector.<sup>10</sup>

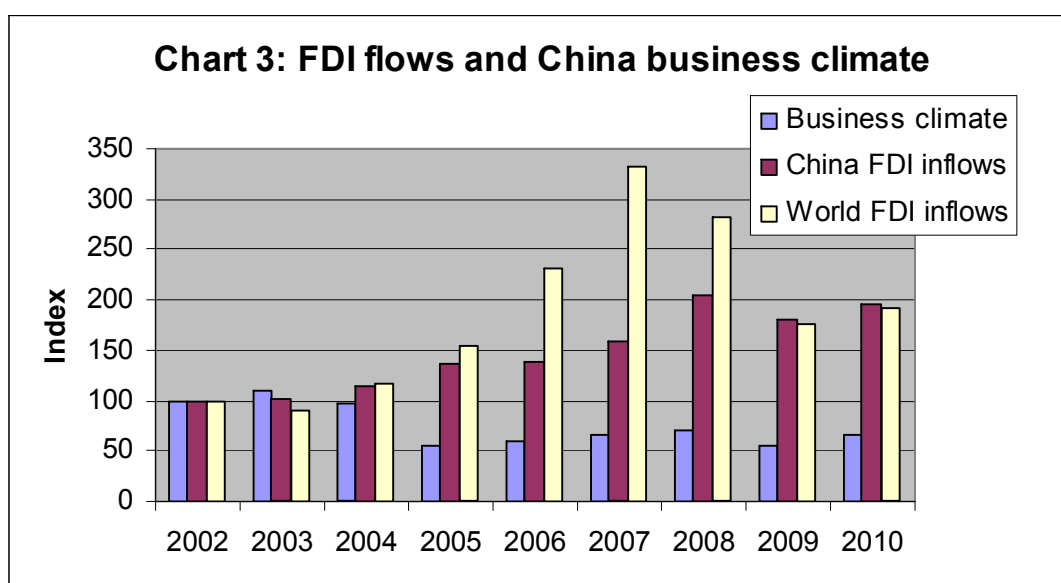
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Part Two: Australian FDI into China

Global FDI flows to China

At the same time that China's FDI outflows have been increasing significantly, FDI inflows into China have also been rising and becoming globally more significant.

Chart 3 shows global and Chinese FDI trends over recent years, along with an indicator of the business climate for foreign investors in China (discussed below).



Sources: UNCTAD *World Investment Report 2010*, Annex table 2; US China Chamber of Commerce, *AmCham 2010 White Paper*, April 2010, Table 39. 2010 global FDI is an UNCTAD projection. 2010 China FDI is the annualised data for the first six months of 2010 from Invest in China website, *Statistics about utilisation of foreign investment in China from Jan. to Jun. 2010*.

The three series have been indexed to 2002 = 100. The business climate index has been derived from the 2010 AmCham survey response to the question: "To what extent do you believe China's recent economic reforms (last three years) have improved the climate for US business in China?" The index is based on the addition of the most positive responses: "to a very great extent" and "to a great extent". The 2006 data point is an interpolation of 2005 and 2007.

Following a significant increase in global FDI in the years leading up to the global financial crisis (GFC), FDI fell sharply in 2008 and 2009. By contrast, FDI inflow into China increased in 2008 and the fall in 2009 was much less severe than the global total.

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China ranked second for global FDI inflows in 2009, having more than doubled its share to almost 9% in two years. For the third consecutive year, China was ranked as the most attractive FDI destination for the subsequent three years.<sup>11</sup> Table 1 shows the top five global FDI source and destination countries, along with rankings for China and for Australia.

**Table 1: Country rankings of FDI flows - global, China and Australia (2009)**

Global FDI		China FDI		Australia FDI	
<i>Source</i>	<i>Destination</i>	<i>Source</i>	<i>Destination (2008)</i>	<i>Source</i>	<i>Destination</i>
US	US	Hong Kong	Hong Kong	Netherlands	UK
France	<b>China</b>	Taiwan	South Africa	Japan	US
Japan	France	Japan	<b>Australia</b>	<b>China</b>	Canada
Germany	Hong Kong	Singapore	Singapore	Singapore	PNG
Hong Kong	UK	US	US	Canada	Hong Kong

Sources: UNCTAD *World Investment Report 2010*, Annex table 1; Invest in China website, *News release of national assimilation of FDI from January to December 2009*; *2008 Statistical Bulletin of China’s Outward Foreign Direct Investment*, Table 1, Ministry of Commerce, National Bureau of Statistics and State Administration of Foreign Exchange, September 2009, from Ministry of Commerce website; ABS *International investment position, Australia: supplementary statistics, calendar year 2009*, Cat. no. 5352.0. Canberra, 2010. The country rankings for China exclude ‘free ports’, mainly the Virgin Islands and Cayman Islands, which could be investment from/to developed countries or reflect ‘round-tripping’ by Chinese nationals.

Four of the five top suppliers of FDI into China were from Asia.<sup>12</sup> The destination of China’s FDI was more widely spread.

The sectoral distribution of FDI (stock) into China in 2008 is dominated by manufacturing (61% of the total). Real estate (16%), finance (2%) and mining (less than 1%) were less significant.<sup>13</sup> This FDI inward stock distribution is in marked contrast to China’s FDI outward stock, with manufacturing (5%), real estate (2%), finance (20%) and mining (12%).<sup>14</sup>

Despite the rapid increases in recent years, China’s FDI inflows are still dwarfed by trade flows.<sup>15</sup>



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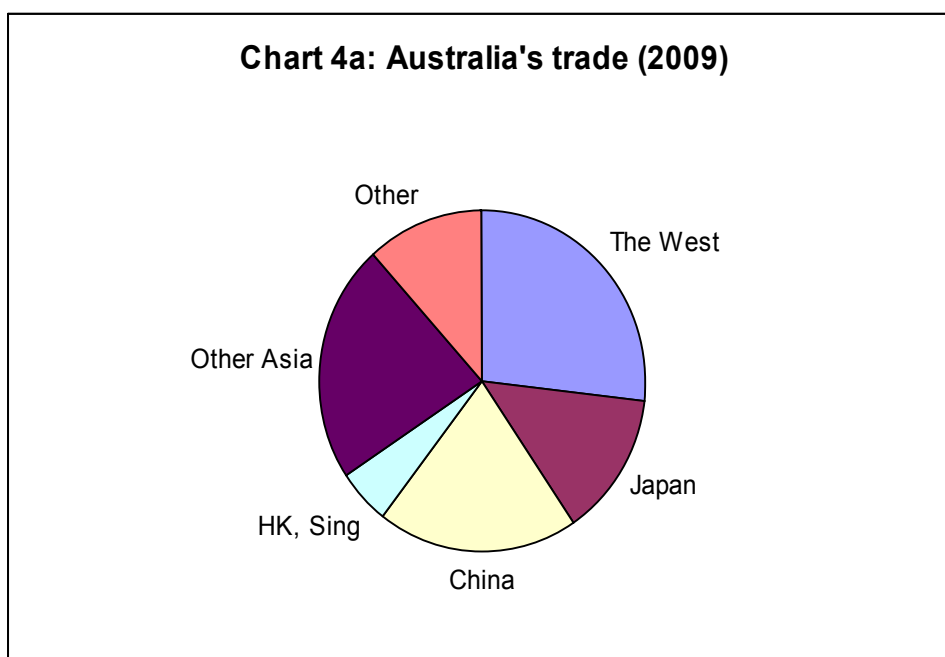
**Australian FDI flows to China**

In contrast to the focus on the bilateral trade relationship and Chinese FDI into Australia, there has been relatively little attention on FDI flows the other way. In large part, this is because Australia's FDI in China has been limited, with China accounting for only 0.7% of Australia's outward FDI stock in 2009.<sup>16</sup> However, in the context of the recent significant increase in actual and approved Chinese investment in Australia (and the barriers faced by China), there has been a renewed interest in the barriers faced by Australian investment in China.

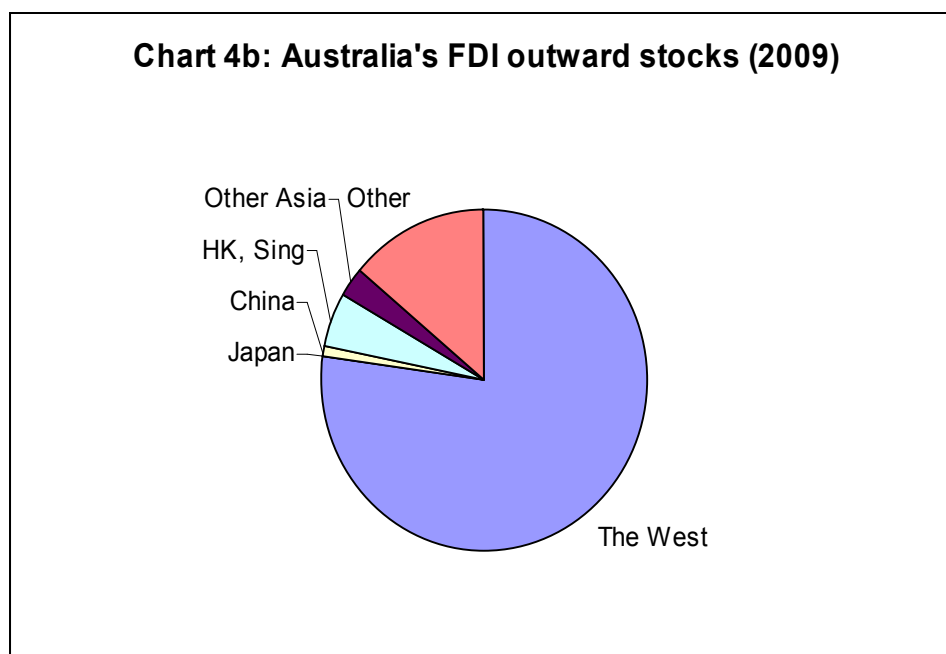
Chart 2 shows that, from China's perspective, in 2009 Australia accounted for only around 0.4% of China's total FDI inward stock. Australia also ranked outside the top 15 countries of origin in 2008. So while Chinese investment into Australia is rapidly increasing – and increasing in economic and political importance – the same is not true for the flow in the other direction.

Should we expect Australia to be a more significant source of FDI into China? Probably not, given that Australia is a capital importer, represents only 2% of the global economy and accounts for less than 2% of global FDI outward stock.<sup>17</sup>

What about from an Australian perspective? One starting-point is to note that the *distribution* of Australian outward FDI is in marked contrast to the distribution of Australia's trade (Charts 4a and 4b). Outward FDI is mainly directed to countries with similar market structures, legal systems and cultures – more than three quarters is located in North America, Europe and New Zealand.<sup>18</sup>



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Source: ABS *International investment position, Australia: supplementary statistics, calendar year 2009*, Cat. no. 5352.0. Canberra, 2010. ABS *International trade in goods and services*, Cat. no. 5368.0. Canberra, 2010. For the purposes of this chart, 'The West' is defined as the United States, Canada, the European Union and New Zealand. 'Other Asia' is defined as ASEAN (excluding Singapore), Republic of Korea, India and Taiwan.

China's 0.7% share of Australia's outward FDI stock is substantially below simple measures of the China 'economic opportunity': a global GDP share of 12% and economic growth projected to continue at around 9% per annum in coming years.<sup>19</sup> Along with surveys showing China as the most desirable global FDI destination, this raises the question of whether the distribution of Australian outward FDI is a reflection of perceived investment opportunities; investment barriers; the greater comfort by Australian investors with countries that have similar markets, legal systems and culture; risk aversion; the delay in FDI responding to the economic opportunities; or other (including historical) factors.

An independent study conducted for the Australia-China FTA<sup>20</sup> estimated that, if all investment barriers were removed (in both directions), Australian FDI into China would be only 8% above the baseline. Given the substantial gap between the proportion of Australia's FDI to China and the economic opportunities, it seems that factors other than formal barriers are much more significant.

A similar picture emerges from other major Western countries – for the US and the UK, offshore FDI is heavily concentrated in Western developed countries. Offshore FDI stocks in China were also relatively low – 1% or less of their respective totals.<sup>21</sup> FDI (stocks and flows) into Japan also appear to be modest, in comparison with its global GDP share.<sup>22</sup>

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The fact that the Australian (and other Western countries') FDI is primarily directed at countries with similar market structures, legal systems and culture could be a reflection of investor preferences *and/or* the formal and informal barriers faced in those other countries.

#### What drives Australian FDI into China?

One way to try to explain the relatively low share of Australian FDI into China is to understand the motivation of investors looking to invest there. Studies of FDI into China have emphasised the importance investors place on the Chinese market and using China's lower costs as a base for exporting. For example, a 2009 UNCTAD survey<sup>23</sup> reported that the top five factors favouring investment in China were, in order of importance: growth of market; size of local market; cheap labour; presence of suppliers and partners; and access to international/ regional markets.

Ma et al<sup>24</sup> argue that Australian FDI into China is driven by the size of that market, rather than the cost of labour. This is consistent with the view that Australian investors are transferring their Australian business model closer to their customers, rather than using China as a base for exporting (as other countries are doing).<sup>25</sup>

Another study by Menzies et al<sup>26</sup> also found that the key motivation for internationalising into China was growth and market development opportunities, especially compared with a limited Australian market. Secondary motivations included cutting costs, following the industry into China or following suppliers.

Liu<sup>27</sup> looked at the factors for Western Australian firms, concluding that the key drivers were market size, infrastructure, lower labour costs (depending on industry) and business ethics. Lower labour costs were more important for those industries engaged in the domestic market and less important for those using China as an export base.

From the Chinese perspective, a 2006 survey<sup>28</sup> showed that Chinese respondents believed that the major motivation for foreign investment in China was for Chinese economic growth (and, to a lesser extent, market size) and not to exploit China's resources or for export.

The view that foreign investment into China is primarily motivated by access to China's market is also supported by business surveys of US and EU companies operating in China.<sup>29</sup> Discussions with a range of Australian investors in China, conducted for this paper, were consistent with this view.

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### Part Three: FDI into China – policies, other barriers and assessment

#### FDI into China – formal and informal barriers

So, if investing in China is seen as attractive, particularly to capture the benefits of a large and rapidly growing market, what are the barriers faced by investors?

Direct investment into China faces many formal and informal barriers. As part of World Trade Organisation (WTO) accession in 2001, China liberalised its foreign investment restrictions but, in many respects, they remain relatively restrictive and opaque.<sup>30</sup>

There are three major types of laws and regulations affecting foreign investment in China:

- laws and regulations specifically targeted at foreign investment, including the corporate structure of the investment (such as joint venture (JV) or wholly owned foreign enterprise (WFOE)) and the categorisation of industry activities/ sectors (see below);
- general laws and regulations applied to the economic activities of both domestic and foreign companies; and
- bilateral or multilateral treaties on investment, trade and taxation relating to foreign companies.

Focussing on the laws specifically targeted at foreign investors, perhaps the most significant is the Catalogue<sup>31</sup> which allocates business activities into four broad industry categories:

- “encouraged”, with a particular focus on advanced technology, energy saving and projects in central and western China;
- “restricted”, including those industries using outdated technology, or deemed to be environmentally unfriendly; those using resources protected by law or regulations; and “industries that shall be opened gradually”; and
- “prohibited”, including those that are deemed to endanger the safety of the State or damage social or public interests; those that pollute the environment, destroy natural resources or impair human health; those that occupy large tracts of arable land; those that endanger military facilities; or those that use Chinese craftsmanship or technology.
- Where an industry does not fit into the above three categories, it is assumed to be “permitted”.

Limitations (in terms of maximum foreign equity proportion) on FDI vary across industries and can vary within each industry category.<sup>32</sup>

Approval processes also differ, depending on the category and the size of investment. In general, larger projects<sup>33</sup> need to be approved by the National Development and Reform Commission (NDRC) after approval by the Ministry of Commerce. Approval is then required by the State Council. Smaller projects

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can be approved by the provinces/ autonomous regions, with approvals in the restricted category reported to the State Council.

Foreign companies can invest in China via a WOFE for the encouraged and permitted industries. A joint venture is usually required for investment into the restricted industries, usually with majority ownership retained by the Chinese partner, often an SOE. In 2009, around 75% of the value of FDI was from WOFEs, with the balance from various JV forms.<sup>34</sup>

Many provinces and local governments also provide their own foreign investment facilitation processes. Provincial and local governments may also have *enterprise zones* within their jurisdictions, with their own set of requirements and inducements.

Using the finance industry as an example, Box 1 outlines China's regulatory arrangements (and highlights their complexity). This industry is of particular interest to Australian investors, accounting for 28% of Australia's total FDI outward stock in 2008.<sup>35</sup> Indeed, all the major Australian banks have a presence in China.

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**Box 1: Chinese foreign investment restrictions for the finance sector (banking and insurance)**

This sector falls into the “restricted” category, usually requiring a JV partner, with different requirements for each sub-sector. For example:

- Banking – no maximum foreign holding specified in the Catalogue, but in practice a maximum of 19.9% for any one bank, with a maximum ownership by a single foreign investor of two banks. An alternative (although slower) path, with perhaps better prospects of foreign investor control, is to set up a representative office, then move to a branch status and (after a minimum of 2 years) move to a locally incorporated subsidiary.
- Insurance – maximum of 49% foreign ownership for life insurance.
- Security company – maximum of 33% with activities usually excluded from trading in local Chinese shares. (Trading in Chinese shares listed offshore is permitted.)
- Funds management company – maximum 49% foreign ownership.
- Trust business (a hybrid of banking, asset management and private investment) – maximum of 19.9% for any one investor and 25% aggregate for all foreign investors.

In addition to these formal legal restrictions, there is a complex array of arrangements for approval and expansion. For example:

- Financial services companies could be regulated by one or more of three regulators: China Banking Regulatory Commission (CBRC), China Insurance Regulatory Commission (CIRC) and China Securities Regulatory Commission (CSRC). Trust companies are regulated by all three. Foreign investors may need to deal with provincial/city regulators, as well as national regulators. In addition, other regulators/ authorities may also be involved in the approval process, such as the Ministry of Commerce and State Administration of Foreign Exchange (SAFE).
- For banking, there are restrictions on expansion in the form of high capital requirements, as well as branch by branch licensing approval.

*Sources: Catalogue for the Guidance of Foreign Investment Industries (Amended in 2007); Invest in China website; China: Fund management and financial services, presentation to IFSA and ABA, Malleons Stephen Jaques, June 2010.*

In addition to these specific FDI guidelines, foreign investors will need to navigate through the broader institutional environment during the FDI application process, as well as when they have established a business. Accordingly, any assessment of China's FDI regime will need to review these broader elements.

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**INTO THE DRAGON'S DEN****An assessment of China's FDI and regulatory regime**

China's economy has undoubtedly opened up over the last 30 years and especially after China's WTO accession in 2001. Trade and cross-border investment flows have increased rapidly. However, despite this opening, there is an increasing sense by foreign companies operating in China that they are not as welcome as before.

The following sections review foreign assessments of China's investment regime.

*(1) By international institutions*

China's formal legal and regulatory requirements and China's compliance with its WTO obligations (and, more generally, its openness to trade and investment) are reviewed by the WTO, by other international organisations and by a number of China's trading partners.

The most recent WTO report on China<sup>36</sup> recognises that China has continued the gradual liberalisation of its international trade and investment regime. The report acknowledges progress on improving the legislative framework and the enforcement of intellectual property rights (IPR) protection as well as the liberalisation of FDI in services (such as telecommunications and tourism). However, other problems, affecting both trade and investment, remain: government procurement and the indigenous innovation initiative; the stringent qualification requirements for banks (including high minimum capital requirements and restrictions on the business scope of foreign bank branches); transparency<sup>37</sup>; and coordination between central and local governments.

The OECD's FDI Regulatory Restrictiveness Index accorded China the highest score (that is, the most restrictive) of all OECD countries and G-20 countries.<sup>38</sup> For the finance sector (see Box 1), China was the most restrictive of all countries.

*(2) By trading partners*

Assessments by China's trading partners tend to be more critical of China's investment environment.

US government reports acknowledge significant progress by China in meeting its WTO obligations but point out important areas where reform has not progressed or where new problems have emerged: "China has yet to implement important commitments, and in other areas, significant questions have arisen regarding China's adherence to ongoing WTO obligations...these problems can be traced to China's pursuit of industrial policies that rely on excessive, trade-distorting government intervention intended to promote or protect China's domestic industries."<sup>39</sup>

In the most recent US Department of State review, there was a long list of issues cited, including: key terms and standards in regulations were undefined; the legal and regulatory system is complex and

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contradictory, and generally lacks consistent enforcement; corruption remains endemic; the foreign investment *Catalogue* is updated without public input or rationale for changes; Chinese regulators are not bound to follow the *Catalogue* (there is significant discretion by regulators to impose unexplained restrictions); there are separate policies in specific sectors that appear designed to restrict foreign participation; and the legal system has an inconsistent record in protecting the legal rights of foreigners.<sup>40</sup>

The European Union (EU) has also been critical, arguing that investment into China should not be curtailed by equity caps, unnecessary JV obligations or restrictions on 'strategic' sectors. The EU also highlights the need for stronger IPR protection, especially patents, if foreign companies are to bring their ideas and technology to China.<sup>41</sup>

Japan also provides an annual assessment of WTO compliance by its trading partners, where the focus is on trade issues with the US and China. In relation to China, one of the major Japanese concerns in the latest report was IPR and China's discrimination in its national indigenous innovation program.<sup>42</sup>

Australia does not provide a formal or regular assessment of WTO compliance or trade restrictions of its trading partners.

The 2005 Australia-China FTA joint feasibility study did not provide a critical assessment of either country's FDI policies, but rather focussed on the opportunities that would flow from bilateral liberalisation. While the study referred to concerns by *both* Australian and Chinese investors, the list of concerns is consistent with the issues raised by foreign investors in China, including: takeover restrictions; IPR enforcement; shareholding and JV requirements; tax and foreign exchange rules; the transparency of approval processes; certainty of rules and criteria; consistency of state/ provincial laws; and domestic procedures for prompt review and correction of government administrative action.<sup>43</sup>

More recently, a speech by Australia's Ambassador to China noted the negative consequences of the close connection between politics and business in China (such as excessive regulation, an often uneven playing field and corruption). In addition, he said that recent policy changes, in the form of 'Buy China' regulations, appear to skew government procurement processes in favour of local firms, particularly for high-tech products and services. He also noted concerns about Australian companies that were required to hand over complete designs of their manufactures, effectively abandoning their IPR, in order to secure a JV with local partners.<sup>44</sup>



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### Foreign investor experience in China

As well as potential barriers to entry, would-be Australian investors in China might be concerned about business conditions once they have entered the Chinese market.

#### *Business surveys*

Business groups operating in China are increasingly vocal about their problems in entering and operating in China. This is despite their stated intentions to expand further in China and their existing profitability.

Recent annual surveys by the US-China Chamber of Commerce reported expansion plans and profitable operations for the majority of US companies in China. However, there was a catalogue of complaints, largely to do with the regulatory regime (inconsistent regulatory interpretation; obtaining licences; bureaucracy; unclear regulations; and lack of transparency). In addition, IPR protection was seen as “ineffective”, or worse, by three-quarters of respondents. Almost the same proportion saw IPR as very, or critically, important to their China business.<sup>45</sup>

A growing sense of feeling less ‘welcome’ in China is reflected in two particular responses in the 2010 AmCham survey:

- In 2005, the survey reported a sharp drop in positive responses to the question of whether China’s recent economic reforms have improved the business climate for US businesses in China. That drop in sentiment has been maintained in subsequent annual surveys (see Chart 1).
- An indicator of ‘welcomeness’ (the net response of positive to negative responses) records only a slight positive net result in 2010, and a weaker result than 2009.<sup>46</sup>

Since at least 2006, the EU Chamber of Commerce in China has also emphasised the key issues as: limitations on investment, IPR and the perception that FDI is no longer welcomed, with an increasing atmosphere of economic nationalism and self-reliance.<sup>47</sup>

A more recent EU survey<sup>48</sup> acknowledged some progress but referred to unresolved issues and new problems: market access; legal and political transparency; and IPR. Protectionism was seen to be on the rise.

A recent article by the head of the EU Chamber of Commerce in China raised the level of public criticism further, referring to greater barriers and a heightened sense of frustration by foreign investors. Recent political developments and regulatory restrictions were seen to be protectionist, adding to existing protectionist policies. One example was the car industry: the Chinese company, Geely, can buy Volvo but foreign car manufacturers still have to form JVs to produce cars in China.<sup>49</sup>

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Individual companies are usually reluctant to publicly criticise the investment regime in China. A recent notable exception was the CEO of General Electric, who was reported as accusing the Chinese government of becoming increasingly protectionist.<sup>50</sup>

A Japanese business survey<sup>51</sup> rated China as the most desirable offshore investment destination. However, China also ranked the highest for “risks and issues”, particularly IPR and the legal system (its “undeveloped state” and “operation”).

Interviews with Australian companies, conducted for this paper, were consistent with many of the business survey concerns, including about the legal environment.<sup>52</sup> But, as with the business surveys, there was a generally positive view about the outlook – and a desire to expand further. There was a concern that Chinese policy-makers would not allow foreign companies to become “too big” in any particular market. In some sectors, the top Chinese companies were “out of bounds” to foreign acquisition. A number of Australian companies were satisfied to operate on the fringes, with a small market share, in a rapidly expanding market. Other companies operated in a niche market, where they could have a more dominant market position with a local partner. In other cases, there was a view that operating in China was too difficult and that exporting to China was a more profitable and less complex strategy. Australian companies had quite different experiences, depending on their industry. In general, mining was seen to be too restrictive; financial services was making progress, especially at the provincial level (for example, banks acquiring the maximum 20% stake in state-owned banks) and with JVs; and some other investors had established good niche businesses. But, equally, even those companies that had established profitable ventures felt very constrained by the regulations.<sup>53</sup>

*Academic studies*

Menzies et al found the key issues for foreign businesses operating in China are: the need to understand the legal environment; ambiguity; contracts were seen as unenforceable; intellectual property (IP) was particularly vulnerable (leading companies to avoid bringing in sensitive IP or to develop risk-minimisation strategies); and rules and regulations (FDI, financial system) were complex and opaque. In addition, there was a significant culture gap (language, communication and the importance of relationship building) as well as the difficulty of attracting and retaining suitable staff – particularly those with an appreciation of the Western and Chinese business and social cultures.

One other critical issue for companies to navigate is corruption. A gift could be a bribe. A recent review<sup>54</sup> emphasises the risks following a recent Opinion from the public prosecutor and the need to maintain a transparent paper trail of invoices and receipts, as well as how to handle some ‘grey areas’.

Liu noted the challenges because of different business standards and practices.

The overall picture from these official, business and academic reports is that China has made some progress but significant barriers remain. In some areas, new barriers have emerged in recent years and

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foreign businesses feel less welcome. Despite this, as Chart 3 shows, FDI into China has continued to increase significantly and business surveys indicate China is still a preferred FDI destination.

### *Key success factors for foreign businesses in China*

Given all these issues, what are the key success (and failure) factors that foreign companies should be aware of in entering and operating in China?

Menzies et al saw the key success factors as: develop a strategic plan; decide entry strategy; assess the political environment; understand assistance provided by local government; prepare for the culture gap, impacting negotiation and operational communication; the importance of relationships rather than contracts; understand the legal system and IPR; get the right people; manage retention; understand WTO and FTAs; prepare for due diligence challenges; and prepare for delayed pay-off.

Using case studies of 25 Australian businesses operating in China, another study<sup>55</sup> emphasised the importance of culture, relationships and the role of government. The key success factors were identified as: long-term commitment; focus on specific opportunity (region, specialisation, niche); the need to be 'best of breed' as a niche player; and adaptability. It also emphasised the need for finding the right customers, as well as the right partner.

Discussions with Australian investors and their advisers, conducted for this paper, reinforced some of these points – particularly the need to develop long-term relationships and trust, as a prelude to a more formalised relationship. A reputable partner was also critical for those companies that were not wholly foreign-owned. There was also a need to understand the structure of government (and decision making) and to appreciate China's political sensitivities. Ensuring that people with Chinese background were key members of the foreign investor team was also very important. (That said, the recent Stern Hu case also emphasises the need for proper governance and oversight by foreign companies.) There was also a need for stability in the senior management of foreign companies in China and to ensure that any Chinese venture had the full support of the offshore head office.

Related to these, was the importance of patience, persistence and flexibility.

### **Are Chinese attitudes to FDI changing?**

A survey of Chinese attitudes towards trade and investment<sup>56</sup> showed a positive attitude towards FDI because of its contribution to economic growth. There was also a recognition that funds from Western countries would be more likely to flow when there is openness, transparency and certainty in economic relationships. Further, respondents saw the benefits to FDI from encouraging a more efficient and fair system of justice and good corporate governance.

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A recent poll<sup>57</sup> tested the attitudes of Chinese towards companies *controlled by foreign governments* buying a controlling stake in a major Chinese company. Of the five countries nominated, investment from only one country (Singapore) was favoured by a majority. Forty seven per cent of respondents opposed (and 41% favoured) an Australian company buying such a stake. There were slightly more supportive results for Canadian investments; and significantly less supportive results for Japanese and US investment.<sup>58</sup>

Informal discussions with Chinese contacts conducted for this paper, including research institutes linked to various Chinese government departments, generally supported FDI, especially in the service sector. This was seen as a way to raise quality of service and to encourage local competitors to do likewise. There was also a view that foreign investors' ability to improve the regulatory/ legal framework would also benefit Chinese businesses that had to struggle with many of the same problems.

However, there is also a harder-line quasi-official view emerging in China, consistent with China's growing confidence across the board: foreign investors overstate their complaints.<sup>59</sup> There is a Chinese perspective that complaints by foreigners about FDI rules should be seen in the context of past generous treatment, for example discriminatory tax benefits that favoured foreign companies. There is a sense that foreigners have been 'spoiled'. Foreign complaints are also seen in the light of substantial changes in China's economic conditions over recent years: China no longer needs foreign capital; Chinese companies are more competitive; there are now stricter rules on the environment; less willingness to provide land at concessional rates to induce foreign investment; and Chinese companies are moving up the value-added chain. Given these developments, the Chinese are not surprised that foreign investors feel they face a harder time.

There is also a Chinese view that foreign complaints about Chinese barriers are an excuse for foreigners' lack of understanding of the Chinese market and the associated policy regime. China can also respond to foreign complaints about regulatory/legal issues by saying (correctly) that local private companies face many of the same issues. These companies are often at a disadvantage to the SOEs that can better navigate the regulatory/legal ambiguities.<sup>60</sup> Chinese officials also argue that China, as a developing country, is still developing many of the relevant laws and regulations.

Of course, these points can also be used by China to deflect genuine concerns about China's FDI policies and other barriers to doing business in China.

More recently there also appears to be a Chinese perception that, regardless of all the foreigners' complaints about China's FDI policy, *foreigners will come anyway*. This is supported by surveys that show foreign investors are planning to increase their investments in China and that most foreign operations are profitable.<sup>61</sup>

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**INTO THE DRAGON'S DEN****The Australia-China Free Trade Agreement**

China's treatment of FDI inflows is also influenced by the various bilateral and multilateral trade and investment agreements that Beijing has signed. For example, as part of China's accession to the WTO, China agreed to changes in laws and regulations concerning inward FDI.

In addition to these multilateral commitments, China has been actively pursuing bilateral FTAs. China has FTAs with ASEAN,<sup>62</sup> Chile, Pakistan, New Zealand<sup>63</sup> and Peru, with varying degrees of coverage over goods, services and investments. The most comprehensive is with ASEAN. In addition, FTA negotiations are underway with at least six other countries or trade groups (including Australia),<sup>64</sup> as well as negotiations about broadening existing bilateral FTAs. Importantly, both economically and strategically, China and Taiwan have also recently finalised an Economic Cooperation Framework Agreement (ECFA), which puts Taiwan on equal standing with other economies that have signed FTAs with China.

Jiang<sup>65</sup> concluded that China's FTA motivations went beyond the official line (including to expand exports, reduce costs, attract foreign investment, increase activity and jobs), to include serving China's strategic and political interests (through strengthening political relations), ensuring a stable supply of energy resources (particularly relevant for the Gulf Cooperation Council and Australia) and seeking recognition of Market Economy Status from FTA partners. Motivations did not include enforcing domestic reforms.

Jiang also noted that China's approach to FTA negotiations was not always compatible with WTO rules. China preferred a selective, gradual approach, rather than a comprehensive undertaking.

These sorts of assessments make for a sobering backdrop to the Australia-China FTA negotiations. In interviews with Australian companies conducted for this project, there was an overwhelming low expectation for the FTA. There was also a view that, if any agreement did eventuate, it would primarily be aimed at political, rather than commercial, objectives.

China has not yet signed an FTA with any major developed country (with apologies to New Zealand). An FTA with Australia, if completed, would therefore be a significant development, given Australia's extensive interests in agriculture, resources, services and investments, as well as its insistence on a comprehensive agreement.<sup>66</sup>

In March 2005 Australia and China agreed to start negotiations on an FTA after consideration of a joint feasibility study.<sup>67</sup> Compared with the more substantial trade relationship, the study noted that the two-way investment flows were modest.

One of the underlying principles of the FTA was the need to be consistent with WTO rules. That said, an FTA was expected to go beyond WTO commitments.

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The study found that there were significant impediments to trade and investment between the two countries. The investment restrictions were noted above, under “An assessment of China’s FDI and regulatory regime”.<sup>68</sup>

The study concluded that there would be “significant” benefits for Australia and China from an FTA, covering trade in goods and services, as well as investment. These benefits were estimated at around 0.04% real annual GDP for both countries over a ten-year period – which is, arguably, not that significant. An FTA was expected to simplify foreign investment screening procedures; enhance transparency; and provide for better protection of bilateral investments. Such measures were assumed to increase the capital stock and improve productivity. In turn, that would induce greater bilateral investment and investment from the rest of the world. The modelling estimates are summarised in Table 2.<sup>69</sup>

**Table 2: Estimated effects of investment and full liberalisation of an FTA**

Percentage deviations from 2015 baseline (from full liberalisation in 2006)		Australia	China
Investment liberalisation only	Australian investment in China	8.2	na
	Chinese investment in Australia	na	7.1
	Real GDP	0.11	0.15
Trade, investment and services liberalisation	Australian investment in China	16.7	na
	Chinese investment in Australia	na	11.4
	Real GDP	0.37	0.39

Source: *Modelling the potential benefits of an Australia-China Free Trade Agreement*, Independent report for the FTA feasibility study, The Centre of Policy Studies, 2 March 2005, tables 5.1 and 7.1.

This modelling provides one estimate<sup>70</sup> of the impact of investment barriers on the “equilibrium” level of Australian FDI into China (that is, FDI would be 8.2% higher). While this estimate is critically dependent on the underlying assumptions, it is striking that the estimate of the impact of removal of investment barriers is so low (as noted above). An 8% increase in Australia’s FDI to China would still mean that such investment was well below the economic opportunity in China. Such an increase would have minimal impact on the direction of Australian outward FDI, which has traditionally favoured Western countries and Asian countries with a similar legal system (Hong Kong and Singapore).

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In July 2010, Australia and China concluded their 15<sup>th</sup> round of FTA negotiations. The DFAT update<sup>71</sup> refers to further progress on trade in goods. But it seems that progress on services and investment continues to be difficult. Some of the discussions covered areas of concern emphasised by China's other trading partners and by industry groups operating in China, such as IPR, government procurement and competition policy.

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### Part Four: Policy issues

China's emergence as a major economic and political power raises significant policy issues for other countries, including Australia. Some of these broader issues arise in the narrower context of Australian investment in China. At its most fundamental level, there is the question of "how do we engage with China?" especially when we come from such different social, cultural, historical, economic and political backgrounds.

#### Engaging with China

Those different backgrounds, and especially the central role of the state in China, can give rise to very different perspectives between China and other countries. Foreign investors in China, who need to navigate through the complex and opaque Chinese legal and regulatory system, can be caught up in political arguments between China and the foreign investors' home countries.

Ultimately China will do business with investors that offer the best prospects for advancing China's domestic development agenda. But investors also need to manage the risk that countries that China sees as 'unfriendly' can be denied commercial opportunities, at least in the short term. Equally, 'friendly' countries can receive commercial benefits. This can create tensions between, on the one hand, foreign businesses trying to enter or operate in China and, on the other, foreign governments that want to maintain what they regard as a 'principled approach' to sensitive matters that China may regard as internal.<sup>72</sup>

Given China's political system and media control, the Chinese government can react to what it believes is unfriendly foreign media and negative comments by politicians, who may or may not be part of the government of a foreign country. Despite an official Chinese understanding that the Australian government does not *control* the media, there is a view that the Australian government can *influence* the media and the public debate.

Chinese sensitivities are not just at the political level. Broader Chinese nationalism should not be underestimated. Despite all the controversy about Google's possible withdrawal from China because of internet filtering, the internet provides the mass of Chinese citizens ('netizens') with an opportunity to vent their feelings in a way not allowed by the political process. Netizen passions can run high. Perceived unfriendly acts by foreign governments can have an impact on foreign companies operating in China.<sup>73</sup> Foreign diplomats and companies in China can struggle to counter populist netizen sentiment (sometimes condoned or encouraged by the state), given the limited opportunities for equal air time in the local media.<sup>74</sup>

Finally, foreigners pressing for FDI policy change must recognise the Chinese government's overriding objective: political and social stability.<sup>75</sup> Every other policy concern is secondary to that objective, whether it is economic growth, income distribution, the environment or foreign relations. And,



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especially given the sensitivities of history, any changes to policy (including FDI), that could be seen to benefit foreigners, will usually need to be clearly beneficial to both sides (a 'win-win').

### What is our bargaining position?

Australia can engage with China in a unique way compared with most other developed countries. Our economic relationship is essentially complementary, not competing. We are not a threat. We do not have some of the historical baggage that other developed countries have with China. We can be an avenue for constructive engagement with China and we have been an early supporter of China's greater global role. Relations are 'friendly' although there will be occasional disagreements, including about matters that China regards as its internal affairs. Chinalco's bid for Rio Tinto in 2009 also raised some tensions.

In our bilateral engagement, we do have some bargaining power with China. Australia is an important supplier of some critical imports to China, particularly iron ore. Related to that, China sees Australia as an attractive destination for direct investment, especially in the mining industry. Less developed countries are also attractive targets for Chinese resource investment, and may not have the same entry hurdles as Australia. But Australia can offer greater political stability and stronger legal protections – once the investment gets through the application process.

All that said, Australia does not rank in the top 10 Chinese export destinations and is a minor source of FDI into China. Obviously, the relationship goes beyond those simple economic facts. But we need to be careful not to overstate our leverage.

This reality constrains the level and frequency of bilateral engagement, especially with so many others knocking on China's door. Australian governments have set up multi-track processes for policy issues to be raised, including Australian investment into China. While the Australian-China FTA remains an important vehicle, at least for now, to press China for market opening at the national level, there are other mechanisms where concerns can be raised and/or progress made.

Given our position, it is difficult for Australia to secure an annual "Strategic Economic Dialogue" (SED), along the US-China model, whereby the US Secretaries of State and the Treasury meet with their Chinese counterparties. However, Australia does appear to be relatively well placed, given the separate annual meetings with the Minister for Foreign Affairs and the Minister for Trade, and their respective Chinese counterparts.

Another avenue for market opening being pursued by the Australian government is at the provincial level. In part, this reflects the Chinese government's priority to increase development in regions away from the coast, and the greater discretion available to provincial governments in promoting investment in their areas (including through special economic zones).

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However, Australia's ability to engage at the provincial level is constrained by the lack of diplomatic and trade representation away from the coast. More broadly at the international level, and not just in China, there is a concern that Australia's network of overseas diplomatic missions is overstretched.<sup>76</sup>

### The Australia-China FTA

The broader details of the FTA negotiations are beyond the scope of this paper but a few general observations can be made.

At least publicly, Australia approaches these negotiations as part of a broader objective of trade and investment liberalisation, consistent with WTO principles. However, in the search for a WTO-consistent 'comprehensive' agreement, the FTA negotiations appear to have inched along over five years and 15 rounds. From the reports of each of those rounds, progress has been very slow. While acknowledging these difficulties, official statements continue to emphasise the need to press on.

We also need to recognise that it is very difficult to persuade China to change its laws or regulations, specifically for Australia.

The GFC may lead to some change in FTA priorities. As the impact of the GFC works its way through the global economy, Asian developing countries (including China) will be rebalancing their growth away from exports and more towards domestic demand. Separately, Chinese government economic policies are emphasising consumer concerns and the need for 'quality not quantity'. All this could mean a new focus on services and barriers to investment into China.

There are a number of examples where Australian FDI into China could benefit from an FTA.

- For banking, a number of Australian banks already hold the maximum levels of permitted investment.<sup>77</sup> Australia could press for greater investment on the basis of the bank's greater stability or credit rating – criteria on which Australian banks currently rate highly. As with some other reforms in China, this could be part of a 'pilot' scheme in a selected region, where a successful scheme could eventually be applied more widely.
- For mining, Australian companies are reluctant to explore in China when there are substantial uncertainties about whether they would be permitted to develop successful exploration. 'Preferential status' to develop successful explorations, provided by the Chinese government, is generally not sufficient comfort to foreign mining explorers.

Depending on the value of concessions offered by China, Australia does have one strong card to play: removing the need for FIRB approval for 'passive' investments by companies that are owned or controlled by the Chinese government.<sup>78</sup> This could be *initially* made available to China and then

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extended to other countries on a case by case basis. While this concession would not be exclusive, China would be a major beneficiary, given the increasing volume of Chinese investment in Australia (especially mining) and the nature of many of those Chinese companies (that is, owned or controlled by the government).

Of course, there are concerns about the potential for state-related companies to act in a strategic, rather than a purely commercial manner. A recent paper<sup>79</sup> argued there were legitimate concerns about such behaviour from Chinese investment but that there was no need to tighten Australia's existing foreign investment framework. In any case, such concerns should be limited in the case of *passive* investment.

But how would such special concessions for China play at the popular and political level? Not well, judging from the negative views towards Chinese investment in the recent Lowy Institute poll, referred to above. Hence this sort of concession to China would be a 'courageous' one by Australian negotiators and should only be contemplated if there were substantial concessions from China.

Another complicating factor in these negotiations is that they involve the respective trade ministries from both countries (Ministry of Commerce (Mofcom, China) and DFAT (Australia)), that need to represent a wide range of interests. The size and complexity of China's bureaucracy and the entrenched interests mean that Mofcom may have limited latitude in negotiating any concessions.

Given the FTA progress so far, there is an understandable scepticism about the extent of real progress and how realistic the objective of a comprehensive agreement may be. This raises the issue of whether to continue on the same FTA track – edging towards a comprehensive agreement or to settle on what has been agreed to date (and therefore compromising on the stated objective). Another alternative is to accept that a comprehensive agreement is not possible at this stage and walk away to negotiate another day. This would obviously mean some loss of face for both sides, especially given the previous high level political support for an Australia-China FTA. Still, perhaps it is better to have no FTA than a bad FTA.

### Reciprocity

At the broadest level, the basis of bilateral trade negotiation is usually one of reciprocity – where both parties make various trade, services and investment concessions. This maximises the benefits to both sides.<sup>80</sup>

However, in pursuing reciprocity, we should not lose sight of the benefits of *unilateral* actions. From a bargaining position, it is best to hold back on concessions until similar concessions can be wrested from the other side. But, if it is judged that the other side is unlikely to concede over a reasonable time frame, then we should not hold that bargaining coin indefinitely. To do so imposes welfare costs on Australia.<sup>81</sup>

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### Multilateral processes

Australia's limited bargaining power and the low expectations of the Australia-China FTA emphasise the importance of Australia's strong support for multilateral processes to address China's formal investment barriers and the regulatory/ legal framework.

China is more likely to engage positively with multilateral organisations of which it is a member, such as the WTO, IMF, World Bank or G-20 (and not, for example, the OECD).

For progress on FDI, the best multilateral opportunity for engagement is probably via the WTO and, in particular, the Trade Policy Review process, which is conducted for each country member.<sup>82</sup>

The GFC has seen the G-20 assume a stronger leadership role in global economic and financial policy coordination. The G-20's mutual assessment process (MAP) is designed to evaluate policies collectively, including whether they are delivering on agreed objectives. Policy assessments will be assisted by international organisations, such as the IMF, World Bank and the OECD.<sup>83</sup> The MAP process has been driven by concerns to coordinate policy in the context of the GFC. Once global economies are on a sounder recovery track, there may be potential to expand such processes to other areas, including FDI.

The G-20 has requested the WTO, in conjunction with other international bodies, to report on trade and investment measures by member countries.<sup>84</sup> In this context, the WTO is careful *not* to make judgments about the consistency of reported measures with WTO and other agreements. This process could be beefed up.

One cautionary note is that the GFC has seen a substantial depreciation of the Western 'brand' in China. The failures of major financial institutions, prudential oversight and macro management in Western countries mean that China will be less willing to take advice or accept criticism from those countries. This particularly applies to the opening up of China's financial sector. These developments will reinforce the notion that "China is modernising, not westernising."<sup>85</sup>

### Other bilateral processes

Given the critical economic and strategic relationship between China and the United States, the annual US-China SED is an important avenue for both countries to discuss key issues, including China's FDI policies. While Australia has no seat at that table, Australia can still coordinate with the United States to help ensure that Australian concerns are understood and that any Chinese FDI concessions will not discriminate against Australia.

Over the last few years, the US-China SED included agreements that, if properly implemented, should benefit *all* foreign investors. For example, in the 2010 SED<sup>86</sup> China committed to simplify foreign

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investment approval procedures, shorten deadlines, enhance transparency and reduce approval and verification scope of reviews. China also agreed to open up a number of manufacturing, services and energy related industries to foreign investment. Importantly, there seems further progress on China's accession to the WTO Government Procurement Agreement, following China's 2009 commitment to treat products produced in China by foreign invested enterprises the same as products produced in China by Chinese enterprises.<sup>87</sup> Importantly, these dialogues emphasised the importance of multilateral mechanisms to dismantle barriers to trade and investment.

Overall, at the official level, it seems that Australia should continue to pursue multi-track processes in attempting to reduce China's FDI barriers. We certainly should not rely too heavily on the FTA. Indeed, Australia should probably give the highest priority to *multilateral* processes with China and encourage other countries to do likewise. Lack of support for multilateral processes can lead to a spaghetti bowl of bilateral agreements, with no uniformity of treatment across countries – not to mention the time and resources tied up in these processes, especially if the end result is essentially political and not commercial.

#### Working with business groups

Another avenue for FDI matters to be raised with China is via the various foreign business chambers that operate in China, such as the US, European Union and Australian Chambers of Commerce. These organisations meet with Chinese officials on a regular basis to address issues. To varying degrees, they also coordinate on common issues, although they are reluctant to be seen to be 'ganging up'.

While these are independent non-government organisations, they should not only be coordinating amongst themselves but also with their respective governments and trade facilitators (like Austrade), to ensure, as far as possible, consistency of approach.

These business groups can also help to ensure that their members operate in China in an appropriate manner, including managing the 'grey areas' of law/ regulation (see below). This will help to demonstrate to Chinese officials, producers and consumers the benefits of foreign investment. It will also help to avoid reputational risk to foreign investors.

#### Consistency

We also need to keep an eye on our own backyard, to ensure (as far as possible) that our treatment of Chinese FDI inflows is consistent with the principles of equality and transparency that we advocate with China.

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In discussions with official and private Chinese contacts for this paper, there was a strong view that Australia's foreign investment regime discriminates against China. Mining investment was the focus of concern.<sup>88</sup> There was also a view that China's attempt to establish a greater banking presence in Australia has been given a tougher time than other countries. In 2009 Chinese sensitivities were also heightened by the very public debate in Australia about the merits or otherwise of Chinese investment.

The ambiguity of FIRB's 'national interest' criteria to assess investment applications can also add to this perception. As noted above, the OECD ranked Australia poorly for its openness to foreign investment, although that ranking did not address discrimination *between* applicants.

How do these perceptions line up with the data? Official Australian pronouncements that "Australia welcomes Chinese investment" can be supported by actual FDI inflows, as well as the increase and quantum of FIRB approvals.

Further, perhaps a large part of the perception gap can be explained by the dominance of China's SOEs as foreign investment applicants. Under the FIRB regime, SOEs are scrutinised more closely than other applicants. The principal concern, as noted above, is that SOEs could behave in a strategic, rather than a strictly commercial, manner. Despite Chinese claims that SOEs act on a commercial basis and China's continuing moves to broaden SOE shareholding, those concerns remain.

In 2008 the Treasurer released a set of principles to try to improve the transparency of the FIRB process for considering foreign government related investment applications.<sup>89</sup>

Despite these moves to greater transparency, it seems that these sensitivities will remain because of the dominance of SOEs as Chinese foreign investor applicants and the ambiguity of 'national interest'. Additional measures to increase transparency and to work with the Chinese to better understand Australia's SOE concerns would help. Encouraging the Chinese to take additional steps to increase the market orientation of SOEs would also assist this process.<sup>90</sup>

### Government facilitation of investment into China

The cultural and informal barriers to doing business in China have been referred to earlier. As part of assisting Australian investors into China, Austrade and other business facilitators need to continue to encourage Australian companies to develop the softer skills essential for doing business in China. This includes building long-term relationships and trust with Chinese partners and ensuring that key members of the Australian management team operating in China should come from a Chinese background.

Going beyond Austrade facilitation<sup>91</sup>, what is the appropriate role for *Australian political leaders or officials* in supporting *individual* companies in their dealings with Chinese regulators and officials?

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Official introductions can be particularly effective at the Chinese provincial level, where there can be significant discretion and a more welcoming approach to foreign investment. The Australian government will be understandably reluctant to endorse any particular commercial venture, company or individual. But such support is an important part of doing business in China; other countries employ it; and Australian companies have benefited – and are appreciative. In providing such support, the government is essentially providing a ‘character reference’ – and any misjudgements could rebound on the government. That reputational risk for individual companies and for the government is heightened by the grey areas of China’s law and regulations.

There are also reputational risks the other way. Such above-board door opening is far preferable to some other avenues that may involve inappropriate behaviour – and legal risks for the companies concerned, as well as reputational risks for Australia.

Against the background of concerns about the depth of Australia’s diplomatic footprint offshore (as noted above), should the government commit greater diplomatic resources to supporting entry of Australian companies into China? The purist view is that such activities are not the business of diplomats. Further, any such expansion would increase the Australian government’s reputational risks, which would need to be carefully managed, with uncertain outcomes. All that said, it seems that such diplomatic entrées are an important part of doing business in China and particularly effective at the provincial level. The case for stronger diplomatic support is greater the broader the potential benefit, beyond an individual company. For example, supporting the entry or expansion of an individual Australian bank, thereby allowing it to build a solid reputation in the China market (particularly given the successful Australian prudential model), should ease the path of other Australian banks into the China market. On balance, this does seem a risk worth taking.

A related issue is the role of Australian regulators in helping support, if not explicitly, the entry and expansion of Australian companies in China. The broader financial services sector is an example, where cooperation between Australian and Chinese regulators, formalised through Memoranda of Understanding (MOU),<sup>92</sup> can provide Chinese regulators with greater comfort about not only prudential supervision of these companies but also the contribution they could play to the development of financial services in China. Understandably, Australian regulators are reluctant to commit significant additional resources to their existing efforts (such as training and Chinese delegation visits), because of concerns that it is a diversion from their primary role. But the likely benefits to assisting Australian entry and expansion in China should also be recognised.

### Operating in China’s regulatory grey areas

In China, foreign companies operate in a very different legal/regulatory environment. In addition, they must manage the many grey areas (the space between what is explicitly not allowed; and what is allowed or required). Some of those grey areas may be by design – to give the regulators discretion to

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interpret the law and shift the boundaries. Properly done, this allows regulators to gradually develop the market, benefitting both producers and consumers.

Other grey areas mean that companies – local and foreign – could engage in practices that are both legally ambiguous and may or may not be ethical. Further, as well as operating under China's laws and regulations, foreign companies are also subject to their home country jurisdictions, for example the Australian *Bribery Act*.<sup>93</sup> These complexities expose Australian companies operating in China to legal, as well as reputational and commercial risks.

The recent Stern Hu case is an example. At the time of this case being heard, there was no clear distinction between legitimate gathering of commercial information and what a commercial (or state) secret is. Subsequent to the case, some (limited) clarity has emerged, with regulations published by the agency that supervises central government-controlled enterprises.<sup>94</sup>

With these local and international risks, foreign companies may understandably choose to operate at the lower-risk end of the spectrum of appropriate behaviour. This may lead to some commercial disadvantage, at least in the short term, against competitors that choose a riskier path.

The various foreign business chambers (including the China-Australia Chamber of Commerce) and Austrade may have an important role to play in assisting companies to understand their dual obligations, which may be unclear or inconsistent.

The Australian government can also play a role, especially in pressing Chinese authorities for greater clarity in laws/regulations that may potentially have an impact on Australian companies. The Australian government can also emphasise its expectations about the appropriate behaviour of Australian companies operating in China – that is, they should conduct themselves with the highest ethical standards. Going further, the Australian government could argue that Australian companies should not be commercially disadvantaged if other companies – local or foreign – choose a higher risk path.

While a higher standard of compliance *may* be disadvantageous in the short term, there can be longer-term commercial benefits. For example, Chinese market reform in particular sectors can often start with a 'pilot' scheme, where the regulators test the water before broader reform, backed by changes in law/regulation. Indeed, this is an example of grey areas – and associated regulatory discretion – being used in a positive way to promote market reform. If Australian companies can build a solid compliance reputation, backed strongly by the Australian government (and perhaps regulators), they should be better placed to be part of such pilot schemes, where there may be significant first-mover advantage.



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### Conclusion

China presents tremendous economic opportunities for Australia, although over-reliance on China's economy carries its own risks. And we should be cautious about extrapolating recent export volume and price growth too far into the future.

As China continues to grow, Australian FDI into China should also increase. But it is unlikely to be a key component of the bilateral economic relationship, given the dominance of the trade relationship and the increasing importance of Chinese FDI inflows to Australia.

China is likely to continue to open up its economy to FDI but it will do so on its own terms, which will be based primarily on domestic considerations. In any case, even with reduced formal barriers to FDI in China, there are still significant regulatory and cultural barriers to investing in China. The impact of the formal barriers should not be overemphasised.

In engaging with China, investors need to navigate complex and opaque policies and regulations. Investors can also be affected by the intrusion of politics into business.

Australia has some, albeit limited, bargaining power with regard to China, given our status as an important commodity supplier to fuel China's economy. Australia is also a desirable investment destination. However, that relationship is unlikely to produce the comprehensive FTA for which Australia is aiming. Indeed, the best mechanisms to persuade China to open the FDI door wider are likely to be multilateral, as well as piggy-backing on the US-China SED.

Foreign businesses (including Australian) operating in China are generally profitable and keen to expand. And despite all the barriers, there are opportunities – for example, the Chinese government's focus on promoting foreign investment into the central and western provinces. The Australian government can play a facilitation role, although that requires resources and management of reputational risks.

China's regulatory grey areas can be a minefield. It is important that Australian companies operate – and are seen to operate – at the low-risk end of the spectrum. Through their Chinese government contacts, the Australian government, Australian regulators and Australian business groups can help to ensure that Australian companies are not commercially disadvantaged by this position. Indeed, properly managed, this can be a competitive advantage as China looks for innovative and high-integrity foreigners to develop the Chinese market.

Finally, the sensitivities of Chinese FDI into Australia are set to remain, especially with the Chinese 'go global' strategy. There will be greater scrutiny and demands for a 'two-way street' for Australian investment into China. China's concerns about discrimination will need to be carefully managed, including emphasising to the Chinese government that SOEs (the predominant Chinese investors in

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Australia) are treated fundamentally differently by FIRB, because of concerns about non-commercial behaviour. But beyond that, the Australian government and FIRB will need to ensure that Australia's foreign investment screening is as transparent as possible – just as we would want Chinese policy towards Australian FDI into China.

## NOTES

<sup>1</sup> The subject of a forthcoming Lowy Institute publication.

<sup>2</sup> FDI is defined as an investment involving a long-term relationship and control by a resident entity in one economy in an enterprise in another economy. An equity capital stake of 10% or more of the ordinary shares or voting power is normally considered as the threshold for control. This is consistent with Organisation for Economic Cooperation and Development (OECD), United Nations Conference on Trade and Development (UNCTAD) and Australian Bureau of Statistics (ABS) definitions. Different thresholds are used in some countries. The UNCTAD definition of "FDI" stock is consistent with the ABS definition of the *direct* investment component of "Australian investment abroad" and "foreign investment in Australia". The UNCTAD definition of FDI flows is consistent with the ABS definition of "financial account transactions".

<sup>3</sup> On a purchasing power parity (PPP) basis. Source: *World Economic Outlook: Rebalancing growth*, IMF, Washington DC, International Monetary Fund, April 2010.

<sup>4</sup> Source: The G20 in 2050, Carnegie Endowment for International Peace, *International Economic Bulletin*, November 2009. This estimate is based on real US dollars. In PPP terms, China would overtake the United States at an earlier date.

<sup>5</sup> Dr Geoff Raby, Australian Ambassador to China, speech to Jilin University, 17 August 2009.

<sup>6</sup> The Lowy Institute Poll 2010, *Australia and the world: public opinion and foreign policy*. The poll was conducted in March 2010. The Poll results were not all positive towards China, with 63% disagreeing with the statement that "Australia's interests would **not** be harmed if China gained more power and influence".

<sup>7</sup> While China's proportion of Australia's *stock* of inward FDI (that is, the level of direct foreign investment in Australia) was only 2.1% in 2009, there was a significant increase in China's proportion of *flows* in recent years. In 2009, China's proportion of FDI inflows was 13.6% (and 5.7% in 2008). If this were to continue (as indicated by FIRB approvals) there would be a significant increase in China's proportion of the FDI inward stock in future years. By contrast, there was a net *divestment* in FDI flows from Australia to China in 2009.

<sup>8</sup> First six months of 2010. Source: China Customs Statistics Information Service Centre website.

<sup>9</sup> China Customs Statistics Information Service Centre. Brazil was the next largest supplier of iron ore (25% share). After iron ore, the next largest Australian export to China is coal, followed by metals and wool.

<sup>10</sup> FIRB approvals from China amounted to \$26.6 billion in 2008-09, 16% of the total value of approvals, ranking second behind the US. This compares with less than 2% of the value of approvals in 2006-07 (11<sup>th</sup> ranking). In 2008-09, almost all the approvals were for the mineral and exploration sector. Source: Foreign Investment Review Board, *Annual Report 2008-09*, March 2010. Since November 2007, 160 Chinese proposals have been approved, worth \$60 billion, with only five of those approvals subject to undertakings, amendments or conditions. Source: Australian Embassy, Beijing website, July 2010.

<sup>11</sup> UNCTAD, *World Investment Prospects Survey 2010-2012* (forthcoming).

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<sup>12</sup> The Hong Kong data could be inflated by some mainland companies using HK subsidiaries in order to obtain foreign investment incentives.

<sup>13</sup> Invest in China website, *Sectoral distribution of cumulative FDI as of 2008*. The sectoral distribution of 2008 FDI inflows is broadly similar, although there was a much more significant proportion into the finance sector in 2008 (15% of total).

<sup>14</sup> 2008 *Statistical Bulletin of China's Outward Foreign Direct Investment*, Table 4, Ministry of Commerce, National Bureau of Statistics and State Administration of Foreign Exchange, September 2009.

<sup>15</sup> In 2009, China's trade was 5 times greater than the stock of inward FDI and 10 times greater than the stock of outward FDI. Source: UNCTAD, *World Investment Report 2010*; UNCTAD *Statistical Handbook 2009*; Ministry of Commerce, *Brief on China Import and Export (2009/12)*.

<sup>16</sup> In 2009, there was a net *divestment* for FDI flows to China, equal to 5.8% of the total Australian FDI outflow. In 2008, FDI flows to China were 2.5% of the total. There is also some question as to whether this data could be inflated by 'round tripping' of investment funds by Chinese nationals resident in Australia. See, for example, Follow the money: it's one way, *Australian Financial Review*, 15 January 2010.

<sup>17</sup> UNCTAD, *World Investment Report 2010*, Annex table 2.

<sup>18</sup> In 2009 Asian countries represented only 9% of Australia's FDI outward stock, despite Asian countries accounting for more than 70% of exports and 50% of our imports. Countries with more similar legal systems (HK and Singapore) accounted for more than half of the Asian total.

<sup>19</sup> Source: *World Economic Outlook: Rebalancing growth*, IMF, April 2010.

<sup>20</sup> *Modelling the potential benefits of an Australia-China Free Trade Agreement*, Independent report for the FTA feasibility study, The Centre of Policy Studies, 2 March 2005.

<sup>21</sup> By contrast, Japan's FDI flows into China over the period 2005 to 2009 averaged around 10% of Japan's total FDI outflows. Source: Ministry of Finance, Japan website.

<sup>22</sup> Given Japan's advanced economy status for many decades, this result raises issues as to the formal and cultural barriers to investing in Japan. The data is for 2009 (US) and 2008 (UK), the latest available as at 24 July 2010.

<sup>23</sup> UNCTAD, *World Investment Prospects Survey 2009-2011*.

<sup>24</sup> Ma Zihui, Yang Ruilong and Zhang Yin, Australia's direct investment in China: trends and determinants, *Economic Papers* 27 (1) March 2008, pp 70-86. The authors develop a "gravity" model of FDI by selected countries in China. According to this model, the key drivers are (with sign): GDP (+), openness (+), population (-), distance (-), language (+) and other external factors of the investing country, such as "small island" and "tax haven". Total FDI into China and total global FDI are not significant in explaining individual country FDI.

<sup>25</sup> The paper also argues that Australian FDI in China is above "equilibrium levels" and "in the absence of policy intervention, the growth in Australian FDI will not be sustained for long", *ibid*, p 85.

<sup>26</sup> Menzies, J, Chung, M and Orr, S, 2008, *Doing business in China: how Australian companies make their decisions when entering the Chinese market*, Deakin Business School, Deakin University, Melbourne, Vic. The study was based on interviews with 40 organisations across a variety of industries, entry modes (such as joint venture and wholly owned foreign enterprise (WOFE) and locations in China.

<sup>27</sup> Liu, Y, Factors influencing the decision making of Western Australian investors in the Chinese marketplace, *Research and Practice in Human Resources Management*, 17(2), 2009, pp 94-108.

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<sup>28</sup> Basu, P, Hicks, J and Sappey, R, Free trade agreements and investment: a Chinese perspective, *Agenda*, 13 (2) 2006, pp 179-192, ANU. The survey data was taken from responses by 1575 students and 74 senior academics at two Chinese universities.

<sup>29</sup> See, for example, the *AmCham-China 2010 business climate survey*, Chart 11, April 2010.

<sup>30</sup> China's WTO accession was announced in the WTO Press Release, *WTO successfully concludes China's accession*, 17 September 2001.

<sup>31</sup> The *Catalogue for guidance of foreign investment industries (amended in 2007)*, of 31 October 2007, provides the details of industries and activities in the three sectors. This decree was approved by the State Council, the highest level of government in China. This summary of the Catalogue also draws on WTO, *Trade Policy Review*, May 2008.

<sup>32</sup> Examples for the financial sector are presented in Box 1. In addition, limitations can apply to both individual foreign holdings and to aggregate foreign holdings.

<sup>33</sup> Larger projects are those valued at more than \$US500 million for the restricted category; and more than \$100 million for encouraged and permitted categories. Source: *Procedures for foreign investors to invest in China*, 26 May 2009, from *Invest in China* website.

<sup>34</sup> Source: *Statistics about utilisation of foreign investment in China from Jan to Dec 2009* from *Invest in China* website.

<sup>35</sup> ABS Catalogue 5352.0, *International investment position, Australia: supplementary statistics*, 2008, Table 16a, May 2009. (2009 data will be available later in 2010.) The industry composition of Australian FDI in China is not published by the ABS. It is understood that unpublished data for China could be limited in value because of the confidentiality of responses, reflecting the limited number of respondents in each industry sector. Anecdotally, Australia's FDI in China would show a significant proportion in the finance sector; some manufacturing and service industry investment; and minimal mining and agriculture investment.

<sup>36</sup> WTO, *Trade Policy Review: Report by the Secretariat, China, Revision*, 5 July 2010. The "Revision" is an update on the more comprehensive *Trade Policy Review, China* of 21 May 2008.

<sup>37</sup> The Report noted that China has continued to take steps to improve transparency but that some elements of China's trade policy regime remain complex and opaque. "Complexity and opacity can leave scope for administrative discretion and thus corruption", *ibid*, p 8.

<sup>38</sup> *OECD's FDI Restrictiveness Index: 2010 update*, OECD Working Papers on International Investment No 2010/3, June 2010. The index covers 48 countries and takes account of equity restrictions; screening and approval requirements; restrictions on foreign key personnel; and other operational restrictions but does not include institutional or informal restrictions on FDI. The index covers 14 industry sectors. China's restrictiveness ranking was higher than the average for all countries in all but one sector (real estate). Note that Australia was ranked the 13<sup>th</sup> most restrictive country. China's restrictiveness index was higher than Australia's for all sectors, except real estate.

<sup>39</sup> *The US Trade Representative's Report to Congress on China's WTO compliance*, December 2009.

<sup>40</sup> US Department of State, *2010 Investment Climate Statement – China*, March 2010.

<sup>41</sup> EC Directorate-General for Trade, Press Release, *EU calls for less barriers, more IPR protection to boost investment*, 8 September 2009.

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<sup>42</sup> Ministry of Economy, Trade and Industry, *Compliance by major trading partners with trade agreements*, March 2010.

<sup>43</sup> *Australia-China Free Trade Agreement: joint feasibility study*, prepared by Department of Foreign Affairs and Trade, Australia; and Ministry of Commerce, China, March 2005, p 82.

<sup>44</sup> *Australia and China: business dynamics and strategies*, Ambassador Geoff Raby, speech to Australia China Business Council, 26 May 2010.

<sup>45</sup> *AmCham-China 2010 business climate survey*, April 2010.

<sup>46</sup> This refers to the “actual situation” of respondents. There was a negative balance for “perception in the foreign media” and a single digit positive response for “perception in the Chinese media”. All indicators deteriorated from the 2009 survey.

<sup>47</sup> President of the EU Chamber of Commerce in China, *A view from EU business in China*, speech to conference: EU trade and investment with China: changes, challenges and choices, 7 July 2006, Brussels.

<sup>48</sup> EU Chamber of Commerce in China, *Position Paper*, 2010.

<sup>49</sup> China is beginning to frustrate foreign business, *Financial Times*, 7 April 2010.

<sup>50</sup> Immelt hits out at China and Obama, *Financial Times*, 1 July 2010. The CEO was quoted as saying “I am not sure that in the end they [the Chinese government] want any of us to win, or any of us to be successful.”

<sup>51</sup> *FY2009 survey on the international operations of Japanese firms*, JETRO, 18 March 2010. JETRO is the Japan External Trade Organisation, a government-related organisation that promotes trade and investment between Japan and other countries.

<sup>52</sup> One issue is the lack of precedent in Chinese courts, leading to uncertain outcomes over time and across jurisdictions.

<sup>53</sup> There is no comprehensive survey of Australian company profitability in China. Anecdotally, performance is mixed, with some companies accepting a lower than normal profit, regarding China as a longer term investment. (This is in contrast to the generally positive profitability reported in the *AmCham* survey for US companies in China.) Using ABS statistics on income credits from direct investment and FDI stocks, the rate of return on investment in China is below the average for all countries (with above average returns for Hong Kong, Singapore and New Zealand). Source: ABS *International investment position, Australia: supplementary statistics, calendar year 2009*, Cat. no. 5352.0. Canberra, 2010.

<sup>54</sup> Jin, Li and Krever, Rick, Doing business in China: is it a gift or a bribe? *Commercial Law Quarterly*, December 2008 – February 2009. Opinion from the Supreme People’s Court and the Supreme People’s Procuratorate.

<sup>55</sup> Suter, K, Armitage, C, Cheng, S, Memari, R, *Engaging China: the realities for Australian businesses*, Australian Business Foundation, August 2009. The case studies covered businesses engaging with China in a variety of ways (including exporting and importing) and not just direct investment.

<sup>56</sup> Basu, P, Hicks, J and Sappey, R, Free trade agreements and investments: a Chinese perspective.

<sup>57</sup> *The 2009 Lowy Institute Poll: China and the world*.

<sup>58</sup> *The 2008 Lowy Institute Poll: Australia and the world* tested sentiment the other way (that is Chinese investment into Australia), finding that the majority of Australian respondents were opposed to a company controlled by a foreign government buying a controlling stake in a major Australian company. Out of six countries cited (including the US and UK), the largest negative response was for Chinese investment.

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<sup>59</sup> Officially, the message is still that foreign investment is welcome, especially high technology and R&D activity. There is also a commitment to continue to improve the legal environment, so that foreign investors operate on a level playing field. See Chinese Premier Wen Jiabao press conference at the Eleventh National People's Congress, Beijing, 18 March 2010.

<sup>60</sup> SOEs enjoy considerable market power, political influence and preferred access to finance. Under central government directives to increase lending, banks will tend to favour SOEs, given their implicit government guarantee.

<sup>61</sup> See, for example, the *AmCham-China 2010 business climate survey*, April 2010. Note an important counter example to this dismissive view of foreign complaints is the Chinese government's Innovation Policy, which was seen by foreigners as discriminatory. Recent indications are that the Chinese government could be back-tracking on some provisions regarded as discriminatory by foreigners.

<sup>62</sup> Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.

<sup>63</sup> The April 2008 China-NZ FTA covers investment flows, providing for 'national treatment' (that is, equal treatment between NZ and China investors in each country). However, there is a critical carve-out: excluding existing non-conforming measures. The FTA did include agreements on additional protections for investors, such as compensation for losses, expropriation and dispute settlement but these are very non-specific.

<sup>64</sup> Australia has FTAs with ASEAN, New Zealand, Singapore, Thailand, United States and Chile. FTA negotiations are underway with the Gulf Cooperation Council, Japan, Korea and Malaysia, in addition to China. Australia's official approach to FTAs is that they should be consistent with WTO rules/ guidelines and should speed up multilateral trade and investment liberalisation.

<sup>65</sup> Jiang, Yang. China's Free Trade Agreements and implications for the WTO. Paper presented at the International Studies Association Annual Convention, San Francisco, March 2008.

<sup>66</sup> The WTO's most recent *Trade Policy Review* of China noted that China's trade with its existing FTA partners still accounts for a minor share of its total trade. *Trade Policy Review, China*, page v.

<sup>67</sup> *Australia-China Free Trade Agreement: joint feasibility study*.

<sup>68</sup> Further issues are identified in the *Australia-China Free Trade Agreement: joint feasibility study*, p 82 and *Modelling the potential benefits of an Australia-China Free Trade Agreement*, Independent report for the FTA feasibility study, The Centre of Policy Studies, 2 March 2005.

<sup>69</sup> The investment estimates were based on assumed reductions in required rates of return and improvements in primary factor productivity.

<sup>70</sup> A significantly larger estimate of the impact of investment liberalisation was provided by the Centre for International Economics, *Estimating the impact of an Australia-China trade and investment agreement, 2008 economic modelling update*, November 2008, a report prepared for the Australia China Business Council. The report assumed a 161 per cent increase in the Australian stock of FDI in China, based on a regression analysis of the OECD FDI restrictiveness index (service sectors) and the inward FDI stock/GDP ratio. The estimate assumed the removal of all investment barriers on a *multilateral basis*. By contrast, and as noted above, the study by Ma et al (2008) concluded that Australian FDI into China was above "equilibrium".

<sup>71</sup> DFAT website. The previous (14<sup>th</sup>) round was held in February 2010, the first since December 2008.

<sup>72</sup> For example, foreign companies operating in China have lobbied their respective governments not to meet the Dalai Lama.

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<sup>73</sup> For example, Chinese calls for a boycott of French products because of demonstrations in France during the 2008 Olympic torch relay.

<sup>74</sup> This risk can lead to some Australian companies underplaying their Australian connection, in order to reduce the risk of a negative Chinese government or popular backlash.

<sup>75</sup> The WTO's most recent *Trade Policy Review* on China expressed this slightly differently: "According to the Government, gradualism in economic reform is motivated by the need to maintain economic and social stability". *Trade Policy Review, China*, p iv.

<sup>76</sup> See Lowy Institute, *Australia's diplomatic deficit: reinvesting in our instruments of international policy*, *Blue Ribbon Panel Report*, March 2009.

<sup>77</sup> Broadly, a bank is permitted two separate investments in city commercial banks, up to a maximum of 19.9% for each investment.

<sup>78</sup> Usually a 15% threshold is used to distinguish between portfolio (or passive) investment and direct (equity) investment that may be associated with voting rights. Under the *Foreign Acquisitions and Takeovers Act 1975* a *substantial foreign interest* occurs when a single foreigner (or any associates) has 15% or more of the ownership or several foreigners (and any associates) have 40% or more in aggregate of the ownership of any corporation, business or trust.

<sup>79</sup> *Is the Foreign Investment Review Board acting fairly?*, Shearer, A and Thirlwell, M, Paper for IPA Conference on Australia's Investment Future, December 2008. The paper noted that there may be divergent interests between Australia and China, particularly where Australian producers have some market power and China is a major consumer (such as for iron ore). However, in addition to the "national interest" criteria for foreign investment applications, there are also domestic policy tools (such as competition and taxation policies as well as corporations law) that can be used to counter such concerns. In any case, if a situation arose where the Chinese government wanted to use economic leverage on Australia, attempting to do so via Chinese investment in Australia may not be as effective as simply restricting the flow of Chinese tourists and students, given the substantial services credits generated from these sources.

<sup>80</sup> In practice, the objective would *not* usually be exact reciprocity within individual trade categories. Nor would developed countries expect exact reciprocity in their negotiations with developing countries. See *Negotiating free-trade agreements: a guide*, DFAT, 2005.

<sup>81</sup> Welfare benefits would usually be expressed in terms of more efficient resource allocation, with benefits to consumers and producers, for example through lower import costs.

<sup>82</sup> As noted above, the most recent China review was in May 2008, with an update ("Revision") in July 2010. Note the current WTO sponsored Doha round of trade negotiations, commenced in 2001, excludes FDI. The Round focuses on agriculture, non-agricultural market access, services, development issues and trade facilitation.

<sup>83</sup> G-20 Communiqué, Meeting of Finance Ministers and Central Bank Governors, United Kingdom, 7 November 2009.

<sup>84</sup> *Report on G20 trade and investment measures (September 2009 to February 2010)*, Joint report by the WTO, OECD and UNCTAD, 8 March 2010. The most recent report, *Third report on G20 investment measures*, 14 June 2010, was a joint report by OECD and UNCTAD only. Like the previous reports, it details investment specific measures taken by individual countries, without critical analysis.

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<sup>85</sup> This sentiment is reflected in many articles and publications. For example, *When China rules the world: the rise of the middle kingdom and the end of the western world*, Martin Jacques, Allen Lane, August 2009.

<sup>86</sup> *Joint US-China Economic Track fact sheet, Second Meeting of the US-China Strategic & Economic Dialogue, 24-25 May 2010*. US Treasury website.

<sup>87</sup> See the *US Treasury fact sheet, following the Strategic and Economic Dialogue, 28 July 2009*. US Treasury website.

<sup>88</sup> In 2009, the focus was on Chinalco's proposal for Rio Tinto. Another example was the amendments to China's Minmetals proposal for OZ Minerals, whereby the initial bid was rejected on national security grounds.

<sup>89</sup> *Government improves transparency of foreign investment screening process*, Media release by the Treasurer, 17 February 2008. Six issues were specified that the Government would have regard to: independence from the foreign government; adherence to the law and standards of business behaviour; impact on competition; impact on revenue; and impact on national security; and impact on the operations and directions of an Australian business.

<sup>90</sup> Encouraging the SOEs in this direction featured in the 2010 US-China SED.

<sup>91</sup> Austrade's focus is primarily supporting Australian exports and inward investment to Australia. Austrade also provides a range of services to assist outward investment, such as information on markets; introductions to potential international partners; access to foreign government and regulators; and general information about establishing an overseas business. Source: Austrade website.

<sup>92</sup> For example, the MOU between the China Securities Regulatory Commission (CSRC) and Australian Securities and Investments Commission (ASIC) and the MOU between the China Banking Regulatory Commission (CBRC) and the Australian Prudential regulation Authority (APRA).

<sup>93</sup> This Act gives effect to the *OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*. US companies are covered by the *Foreign Corrupt Practices Act*.

<sup>94</sup> China shares its meaning of 'secret', *Sydney Morning Herald*, 28 April 2010. The categories of potential secrets include management methods, business models, resource reserves and product specifications.



## ABOUT THE AUTHOR

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