Submission to the Enquiry on Diversifying Australia’s Trade and Investment Profile

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Summary:

This document primarily addresses terms of the enquiry concerning export markets and investment in the context of “any one market” ie Australia’s political and trade relationship with the PRC. I have assumed that while multilateral agreements are best in principle, bilateral trade agreements are a more politically realistic way to enhance trade and investment and that the current or any future government would continually seek more and deeper bilateral agreements. I have not made an analysis of industry or government preparations to diversify trade or reduce reliance on foreign investment. I have briefly discussed import vulnerability in the context of our trade profile and related risks.

Innoculating Against Coercion:
The reason for this enquiry is China and risks that relate to our political relationship. Australia has export and import vulnerabilities and China has a history of weaponising trade and currently is using these to coerce our nation. China also has risk of a major economic downturn and uses policy intervention to help its industries procure raw materials cheaply.

Diversification Not The Only Strategic Choice:
Many industries cannot diversify, but there are other ways of managing risk.

- Austrade could add advice to industry as part of its function.
- State and Federal governments should use conservative assumptions of tax revenue related to China bound exports and not rely on a steady flow of funds from that source.
- Aggressive defensive measures to turn gas and iron ore exports into a strength, should be seriously considered, such as facilitating the power to control export quantities or pricing being granted to the Minister for Trade for use as a negotiating tool in the event of a trade or political dispute.
- Australia should cooperate with nations that supply competing products to present a united front for negotiating resolutions to trade bullying. The political mood in Canada today and their shared challenge would favour such an effort. China would never abide by a WTO ruling in the current environment, necessitating direct negotiation.

Foreign Investment Risks Must Be Managed:
With regard to investment, national security issues have already become effectively identified, but issues remain:
- The axis of coordination between the CCP, United Front organisations, and Chinese corporations. CCP provides guidance, United front provides the workforce, corporations can channel money and in-kind resources. Intelligence services and law enforcement need to more clearly understand these links and activities.
- Outward investment policies can change suddenly in China, leading to external shocks in investment recipient markets.
- Market access can be used to depress the value of an Australian business with high China export exposure, to enable below market price acquisition. FIRB procedures need to take this explicitly into account have a strategy to inhibit it.

Imports and Import Substitution:
Key raw material imports and reducing dependence on trade as a proportion of the economy are also ways to secure our nations sovereignty and freedom.

Is Australia Too Reliant On Any One Market For Exports ?

There are two aspects to this, country and product reliance.

Product Reliance:
Australia's reliance on Coal and Iron ore stand out at a combined over 30 % of exports. Threats to both include reductions in demand (generally due to lower world economic growth), increase in non - Australian supply and development of substitutes. Coal could suffer through development of lower greenhouse gas emitting electricity sources, Iron ore will be required less as major international infrastructure projects are completed and recycling becomes a significant source of steel in China.

Australia's reliance on these two commodities should be a source of concern because of their overwhelming importance to export contribution and any threat to volumes sold and pricing (thereby total export values) would have a material impact on Australia's trade position and overall economic stability. This provides a reason for analysis and a justification for potential policy intervention around the financial stability of major companies in these industries to cope with a downturn. Governments pay special attention to the banking system for national stability, two industries that constitute key exports should also warrant special attention due to their outsized influence on the national interest. It should also mean that for budgetary purposes, the levies and taxes that state and federal governments expect from these industries should be based on an estimate of mid range pricing, with the benefit from boom years used to pay down debt to build financial strength of government budgets.

Country Reliance:
38 % of Australia's exports go to the PRC - and most of these are currently concentrated in a small group of industries. Most of these are industrial inputs.

Country reliance is beneficial where there is longstanding trust and cooperation between these nations. To a business person, trade between Australia and New Zealand, or between Canada and the US lacks the complexity often associated with international trade. The ability to use the laws of the nation you are trading with, to remedy a dispute is relatively straightforward, and politics is unlikely to lead to any effect on business. Canada's trade relationship with the USA of approximately 75% of exports is a beneficial strategic asset, one that neither nation should abuse. A major re-work of NAFTA has a relatively minor impact compared with the disruption caused by Chinese boycotts of Canola and other significant Canadian exports.

Businesses need to select and manage their sales portfolio in line with their risk management procedures and market demand. Generally speaking, their risks are their business. I recommend that coal and iron ore be given special attention primarily because of their high proportion of total exports.

The nature of the regime in China is such that hostility to outsiders is government policy, in order to unite the nation, and CCP control of the nation is the primary goal of the CCP - beyond any other goal including economic welfare. For this reason our exposure to China would be regarded as an economic and strategic risk, even if it was much smaller.

China presents risk at a national level for two main reasons:

1 Interventionist policy aimed at suppressing prices of raw material imports.
2 Direct use of trade policy as a weapon of political manipulation

Intervention To Suppress Pricing:

Examples of price suppression, when politics was not a motivating factor include the battles in the 1980's with the PRC textile buying monopsony and the Australian Wool Board, where the PRC would maintain stockpiles, not buy, and wait out the Wool Board until it had to capitulate. In the early to Mid 2000's PRC media directed a hate campaign against Australia over "exploiting" China by having an "unfairly high" iron ore price. After trying and failing to coordinate buying activity, PRC authorities opted to simply arrest Stern Hu - a high profile Rio Tinto sales executive, highlighting the risks of having a large business exposure to the PRC. He was branded a traitor in the media for over a year, before a "trial" creating a stark warning to Chinese who might consider working for western companies. The message being, "They can pay you, but you must actually work for us". He may well have committed a crime, but he was targeted because of the high price of iron ore. In the case of iron ore, so far, market forces have been too strong for the PRC to defeat, but trends in steel recycling, the development of the Simandou Iron Ore resource in Guinea, and the eventual return to normal supply of Brazilian iron ore will create, with policy assistance, the opportunity for China to rein in iron ore prices.

Despite China's dominance in the Iron Ore market, major companies appear to have already attempted to diversify. Rio Tinto sells 45 % of their iron ore to China, BHP 55%, which in both cases is a high exposure, but allows them to resell cargoes on the water in the case of buyer default or government boycott. FMG is highly exposed at 93% of sales, partially explaining its lobbying for and on behalf of the CCP, which is a political not economic threat.

Intervention In Trade For Political Ends:

Weaponisation of trade as a political tool is business as usual for China. Some recent examples of China's weaponisation of trade for political or strategic goals include the following:

Japan	Rare Earth supply being cut abruptly
South Korea	Coordinated consumer boycotts of group travel and consumer goods due to implementation of THAAD missile defence system
Palau	Chinese tour groups halted, damaging the tourist industry due to Palau's diplomatic recognition of Taiwan
Canada	Canola import bans related to arrest of Meng Wan Zhou (Huawei CFO and daughter of Huawei founder Ren Zheng Fei
Australia: recent years:	
Wine	costly customs / quarantine clearance delays
Meat	costly customs / quarantine clearance delays
Coal	costly customs / quarantine clearance delays
May 2020	
Barley	80% tariff imposition
Meat	import halt for major abattoirs
tourism	public threats at Ambassadorial level
education	public threats at Ambassadorial level

It should not be controversial to suggest that a dollar of exports to China is worth less than a dollar earned from more reliable markets, due to the attached risks associated with dealing with a nation with a first world sized market but third world political and legal institutions.

With regard to political risk, China has attacked other nations, they have attacked us, and they can reasonably be expected to attack again. We need policy approaches to prepare for this. In many cases diversification will not be possible, as China is the main or even only buyer for these commodities, eg iron ore, wool, barley.

Potential Policy Approaches:

At Company Level:

1. Diversification
2. Financial Strength - low gearing
3. Financial innovation - factoring of trade receivables to financial institutions that can manage country and payment risk.

At Government Level:

1. Austrade should cease to be primarily a trade cheerleader and add to it's role, liaison with industry about impending risks, eg informing grain producers well ahead of crop planting that China is likely to impair the market access for barley, and they should consider options like planting wheat or forward selling barley to a trading house that can themselves plan ahead and employ risk management strategies.
2. Manage State and Federal financial budgets making conservative assumptions about commodity receipts from high risk countries - which primarily means China.
3. Formulate policy to turn weakness into strength, ie create the legal and organisational framework such as the potential to create (for example) an iron ore marketing board, where the Australian Federal Minister for Trade could credibly threaten to slow exports of iron ore and gas to China (forcing up prices) as punishment for an aggressive action from China, eg the current 80 % barley duty. Depending on supply and demand at the time, we can be a vulnerable producer of primary products, or an energy and raw materials superpower. While compensating gas and iron ore producers to slow shipments could be costly, it may be cheaper and more reliable than many options of building a conventional defence arsenal and more appropriate in most likely political conflict scenarios. There is no point in taking China to the WTO in a trade dispute as they have shown repeatedly that they will not obey judgements from international institutions if it goes against them.
4. Building a strong rare earths industry in cooperation with allies is necessary to break the Chinese monopoly on these inputs. This is an idea that has already gained support and action.
5. Global cooperation. When Canada can't sell Canola, Australia steps in to undercut them. When Australia can't sell Barley, Canada would generally step in, but in 2020, USA may now do so due to the most recent US - China trade deal. China currently successfully divides and rules. Forming organisations of major agricultural exporters to form a united front against Chinese manipulation would be fraught with difficulty and complexity, but working closely with Canada and New Zealand to negotiate with the US and China just on agriculture may be workable, especially if it was genuinely aimed at protecting fair multilateral trade.

Selecting Priority Industries For Strategic Attention:

The PRC has detailed state directed policies for all major industries, so it makes sense for us to understand what they do and why, and have policy prepared to defend our major and exposed export industries when required. The larger the industry and more dependent they are on China, the more likely we should consider special attention or intervention.

A rough model of selection criteria for selecting industries for government focus is illustrated in the following diagram with illustrative examples (Red means danger - build a plan):

Priority Industry Selection Criteria:

	Low China Dependence	**High China Dependence**
Large Share of Australian Exports	Thermal Coal Wheat	Iron Ore Education Coking Coal LNG
Small Share of Australian Exports	Milk Products	Wine Barley Beef Wool

A more robust industry prioritisation model could be developed using specific measures such as Large Share of Australian Exports being defined as over a selected level, ie 7 %, and High China Dependence being a specific share of EBITDA derived from total sales to that market (domestic plus export), perhaps over 15 %. These would be industries that should have a plan developed, even if in many cases the plan was to do nothing right now, but to have a strategy in place to support these industries in the event of sales in China being curtailed by a sudden economic crisis or a political coercion event. This doesn't mean other industries would be ignored, but due to lower risk or lower national significance, they would not be prioritised and would be encouraged to assist themselves through industry organisations and their own means.

Foreign Investment:

Foreign dominance of Australian investment is driven primarily by the fact that the Australian economy typically has a high growth rate due to a high rate of population growth.

Tax Biases Against Local Investors:
The primary driver of investment is potential after tax profitability of investment. Good projects will find funding from local or international sources. Unfortunately our system of corporate and personal income tax gives substantial legal and also some inappropriate advantages to foreign investors, which is a factor in reducing local control for some projects.

If an Australian based investor considers an investment using a corporate form, then they will pay corporate tax at the same rate as a foreign investor. But after corporate tax, an investor in a low tax domicile will not need to pay the high personal tax rates we pay on profits once distributed. They thus have a lower overall tax bill on an Australian investment - hence we sometimes observe Australian investors moving to Singapore for tax purposes even if investing in Australia. The same investment is worth more to someone in a low tax domicile than someone in a high tax domicile, enabling them to outbid the investor in the high tax domicile.

Various techniques like lending money from the overseas parent company to the Australian subsidiary and paying interest roughly equal to expected profits to have close to zero taxable interest are ways a foreign investor has a tax advantage over an Australian domiciled investor. Early last decade this author paid more tax than Glencore to the Australian Tax department, despite operating a private commodity trading company only a fraction of the size. In general local or foreign investment is neither better nor worse, except that we should provide a level playing field for local investors, starting with tax treatment, if we want local investors to be more prominent in Australian industry.

Foreign Investment - Risks Vary With Country Source:

Concern Is China
Investment by French, Indonesian or most other country's state owned enterprises does not appear to contain any substantial risks. There may from time to time be a case for concern about some types of PRC originated investment, both state owned and private, due to the overbearing influence of the CCP in all areas of Chinese life, including commercial enterprises, including state owned, publicly listed and privately held:

Currency Transfer Restrictions / Real Estate:
Where private individuals or companies are moving funds out of the PRC in ways that breach PRC laws, speed of transfer rather than investment criteria may be the priority, and markets (especially residential and large scale real estate) may be pressured upwards in ways that are unsustainable. A market decline and a fall in real estate related stamp duties could cause volatility in state government budgets. At this time I would not suggest regulation although the NSW government did act to raise stamp duties for foreign buyers due to concern about market overheating, and the revenue opportunity it presented.

Chinese Government Outward Investment Policy Changes:
Several large projects, notably WanDa group projects in Sydney were forced into sudden sales because state directed finance was redirected and the outward investment plans of these large companies fell outside the abruptly changed policy of the Chinese central government. This caused minor economic disruption in Australia, but the potential is there for flow on effects to suppliers and workers.

Market Access Denial To Deflate Asset Values And Force Acquisition:
Where access to the Chinese market is required, non-tariff barriers like long delays in approval for sales (A2 milk / Bellamys) or quarantine delays (wine, meat), the value of an Australian investment of a business that exports to China may be lower to a non-Chinese investor than to Chinese owners who can be expected to get preferential treatment in that market. FIRB should take this potential into account, and demand that market access problems be resolved before an asset sale can go through, allowing the current owners the possibility to extract true value from their investment or retain ownership after value is restored by market access. This policy would be costly to implement in the short term, as Chinese authorities would want to play the long game to force cheap sales of assets and withhold whatever was being held back. The alternative is for Australia's China exports to be dominated by Chinese companies over time, with most of the value added lost to Australian interests. If you don't fight - you lose.

Embedded Political Staff:
Where large state owned or publicly listed PRC companies invest in Australia, they are not guided purely by profit opportunities, but will also be guided by both direct instruction and general policy directives as interpreted by CCP (political department) staff based in the company headquarters. Commercially, I am not aware of any significant <u>commercial</u> problems with this at this stage. The problem is political influence:

Political influence embedded within Chinese corporates has the following implications:

Security:
Security implications of any foreign investment should be considered before proceeding with an evaluation of economic and other issues. In most cases this would be straightforward, however, in the case of an investment in a port or defence sensitive investment (eg Darwin port purchase), it may be more complex. If approval is given with explanations, the public will be more accepting of potentially controversial investments. Post COVID, the threshold for FIRB scrutiny should either be lower for all foreign investors or lower for foreign investors from specific countries deemed high risk.

Political Influence:
Foreign and local companies have a legitimate right to transparently lobby governments to assist in business development and protect their legitimate interests. There are significant controls on how this is done and it is beyond the scope of this document to explore this. What makes state owned, publicly listed and privately held Chinese firms different to those of other nations is the deference required to the requirements of the nation as defined by the Chinese Communist Party. “Political” staff in Chinese enterprises have a role that is more important than that of Finance or Marketing and the nature of their role in Australia is not obvious. The potential to donate or assist organisations that further CCP aims in Australia is one. The potential to offer jobs to former politicians or public servants, former ambassadors, diplomats or academics is another, in return for influence. While the core vehicle of influence is the United Front network, corporations have an integral role to play.

Two examples:

1 Medical Equipment Buy Up, Feb 2020.[1]

In February of this year, CCP United Front organisations with the knowledge and perhaps assistance of the Chinese diplomatic representation in Australia conducted an emergency mass buy up of medical clothing and other equipment to be sent from Australia to China as the COVID spread became more apparent.

- China Southern Airlines supplied cargo flight services.
- Real estate company Country garden organised staff time to source material and make purchases including 100 000 items of protective clothing.
- Yuan Yuan Ping, an individual with a Chinese military background organised logistics and finance.
- Sydney Consul General Gu Xiao Jie officiated at a send off ceremony for the first of two plane loads of equipment.

Such fast and efficient operations are only possible with CCP coordination between corporate entities and social organisations, coordinated by the party apparatus. Political direction is a unique feature of Chinese corporations, irrespective of state or private ownership. Chinese corporations could provide funds (probably tax deductible !) to organisations that seek to undermine Australian interests, especially those that seek to turn Chinese of Australian descent against Australia and in favour of the CCP goals. Identical events occurred in Canada and in other nations around the world. The issue is not simply the event, but the demonstration of the power and means to work in detriment to Australia’s interests, at high speed and efficiency, which could be used for other purposes in the future.

2 Telling China’s Story Well And Australia’s Story Badly.

The Australia China Relations Institute (ACRI) at UTS replaced a respected China Studies centre and was established with funds from expelled United Front figure Huang Xiang Mo (黄向墨). Despite this, it still exists, and its external funding is primarily by Chinese state enterprises and Australian companies currying favour with China. More disturbing, is that the majority of its funds now come from the UTS itself, while the control and influence remains unchanged. It’s economic reports are framed to foster a mindset of dependence on the PRC, and other documents are generally geared to obscure problems and “normalise” the role of a hostile dictatorship in relations with Australia. The CCP leverage a local voice to speak on their behalf, which is one of several propaganda strategies openly advocated in speeches of senior Chinese leaders.

[1]2020年02月25日 16:47　来源：中国侨网 (China Overseas Net, 25 February 2020).

The potential for Chinese enterprises operating in Australia to influence our politics and society is real and a threat. It is best countered by transparency and by all members of society (companies, government, education sector) having a better understanding of how China works and what their strategies are. After all, the main activity of a Chinese enterprise, state or other, is still business. Australia should always be open for business, unfortunately, due to CCP actions, the presence of Chinese enterprises requires special considerations and measures.

Potential Policy Approaches:

1. **Lower FIRB Acquisition Threshold:** Currently the FIRB threshold is zero, as a temporary measure due to the depressing effect of COVID on asset prices. Post COVID, FIRB should use a lower target for permission either for all investment sources or from the PRC or where ultimate ownership and control is deemed likely to be the PRC.
2. **Resolve Market Access First:** FIRB should consider whether the reason for a sale is related to market access barriers and insist they be resolved prior to sale being permitted.
3. **Monitor And Understand Chinese Corporations:** Intelligence services should prioritise monitoring and understanding the non-commercial activities of staff of Chinese enterprises in Australia. As a general rule this should be done primarily through active monitoring of publicly available Chinese language media reports, which would avoid infringing on the rights of the individual that should be expected under Australian law. They should determine who are commercial staff and who are political liaison, and in many, perhaps most cases the lines will be blurred.
4. **Donations Are Never Free:** Non - business spending / donations of many kinds (political, educational institutes, think-tanks) should be limited, with the aim of inhibiting foreign influence. While necessitated by Chinese past actions and known and demonstrated intentions, this could potentially apply to all wholly or majority owned foreign companies, not just those from China.

Critical Material Import Security

Missing from the scope of this enquiry is specific reference to strategy around resilience re critical imports. I believe it is implicit in the discussion of trade and security. Imports of some key materials are concentrated in China.

In addition to existing military and health stockpile preparedness, Australia requires a stronger national security perspective on essential supply chains. Government should work with industry bodies and companies to understand potential vulnerabilities and develop strategies to deal with those that arise. There are situations where the incentive for an individual company is to rely on current sources and maintain low inventories, but collectively, this may be inappropriate for the nation in a time of threat to established supply chains. Consider the following examples:

Critical Agricultural Inputs:
The vast majority of agricultural chemicals for stockfeed, and herbicides and pesticides for crops, are imported from China. The stock is held by importers who financially optimise inventory levels. These commodities are easy to overlook and a very low percentage of overall cost of production. If supply were cut off, Australia would have minimal supply nationally, and agricultural productivity would be affected. Some of these products could be made as byproducts of the mining and metals industry, but China has a comparative advantage based on less expensive labour and lower environmental standards, and deeply embedded and advanced policies of self reliance.

The two major sources of phosphate rock for fertiliser manufacture are China, and other high risk locations, Egypt and North Africa. In addition to local production, finished fertiliser eg DAP, comes from state enterprises in China. As a national security strategy, building an emergency inventory in times of low global prices, identifying local resources and having a local mine plan shovel ready in case of supply being shut off, may not cost much and would pay off if ever required. Other key fertiliser products, urea and potash also require development of strategic options.

Transportation:
Oil supply has been identified as a commodity that requires a strategic stockpile, however this is simply the starting point for an analytical process to build a strategy for how Australia should cope if trade with the world is cut off by an aggressive military force. True resilience in the case of a disruption to trade would require a full analysis of what is required, and in the case of crude oil refining, restricting the import of a handful of container loads of a chemical called **furfural** means after a period of time, crude oil cannot be refined in Australian refineries. Furfural is mainly supplied from China.

There are real risks in our import profile that could be assessed at relatively low cost through research and consultation with various industries deemed strategic. This would be led by government, in consultation with relevant industry groups and corporations.

Critical Technology:
Critical technologies such as closed circuit TV cameras (Hik Vision, DaHua), drones (DJI), Huawei 5G Technologies, have been identified as presenting various levels and types of risk, and a big picture strategy for what is and what is not acceptable not just for government use, but also beyond government should be created and implemented. Concurrent with this, identification of which critical technologies only come from China and could be cut off in the event of a diplomatic spat should be identified and a plan B developed to facilitate economic resilience and therefore political strength.

This is not to say that government should subsidise local production, or inhibit import decisions by private companies. Some vulnerabilities are not obvious and we should understand where they are and have a plan to cope in the event of a disruption in import supply of critical raw materials or technologies. This could mean some stockpiles and some manufacturing (or simply plans with pre-approval in place) that could be ramped up in event of a requirement.

China itself, may provide a model, or at least ideas that can be considered and adapted, for how to plan for self sufficiency and hold stockpiles for emergencies. They are extremely advanced in resilience planning and hold large, many would assume, excessive and unnecessary stockpiles of basic and essential goods. It is unclear whether this is due to paranoia or future intentions.

Reducing Australia’s Economic Reliance on Trade As a Long Term Goal:

Strategies should be employed to reduce our import and export dependence and not reduce trade in absolute terms but may reduce imports and exports as a proportion of GDP by growing the domestic market and domestic production.

Reduced commercial vulnerability gives us increased strategic flexibility. Some policy prescriptions to consider with the goal of increasing local production and mitigating the effect of “Dutch Disease”, where high exchange rates due to commodity success has killed other businesses include:

1. Larger Domestic Market: Post COVID, we should return to and extend the growth oriented population policy. Higher population creates a larger local market making economies of scale for import substitution more feasible.

2. Question the commitment to a floating exchange rate. Many modern manufacturers with skilled staff and automation can make money at 70 or 80 cents to the USD, but disappear at USD parity, never to return. It may be viable to cap a rise in the USD by intervention other than ultra low interest rates and accumulate foreign exchange at times when exchange rates are exceptionally high.

Conclusion:

Australia's exposure to China as an export market exposes us to substantial economic risk and unacceptable political compromise. Diplomatic disputes are unavoidable due to CCP control of China and it's need to manufacture conflict with the outside world to unite its people behind it and distract from it's dramatic domestic problems which have intensified due to COVID. This phenomenon is likely to intensify during this decade. Chinese policy will be to work to assist its industries to reduce costs and use international commerce to extend it's power. Australia needs to "coercion proof" its economy and work to turn control of China's key imports into a defensive weapon. Diplomatic cooperation with other commodity exporting countries who currently or may in future suffer Chinese trade coercion would assist to build joint defence, as China's bullying strategies are dependent on division and a lack of solidarity and policy coordination among nations.

Foreign Investment concerns may be overstated, and in general we should welcome FDI, however minimising investment volatility driven by abrupt Chinese policy changes, protecting Australian companies from a strategy of losing market access in China, losing value, then being bought cheap, and restricting political influence via Chinese corporations are overdue and important goals of industrial and trade policy.

Australia's import related strategic vulnerability goes beyond obvious health and defence materials and requires industry wide strategy paying close attention to essential industrial inputs. As a nation with plentiful raw materials, a first world political and legal system, and sufficient educational levels, we should look at policies that create a positive environment for local production without unnecessary market intervention including continuing to grow the population to create a larger domestic market and reduce reliance on trade overall.