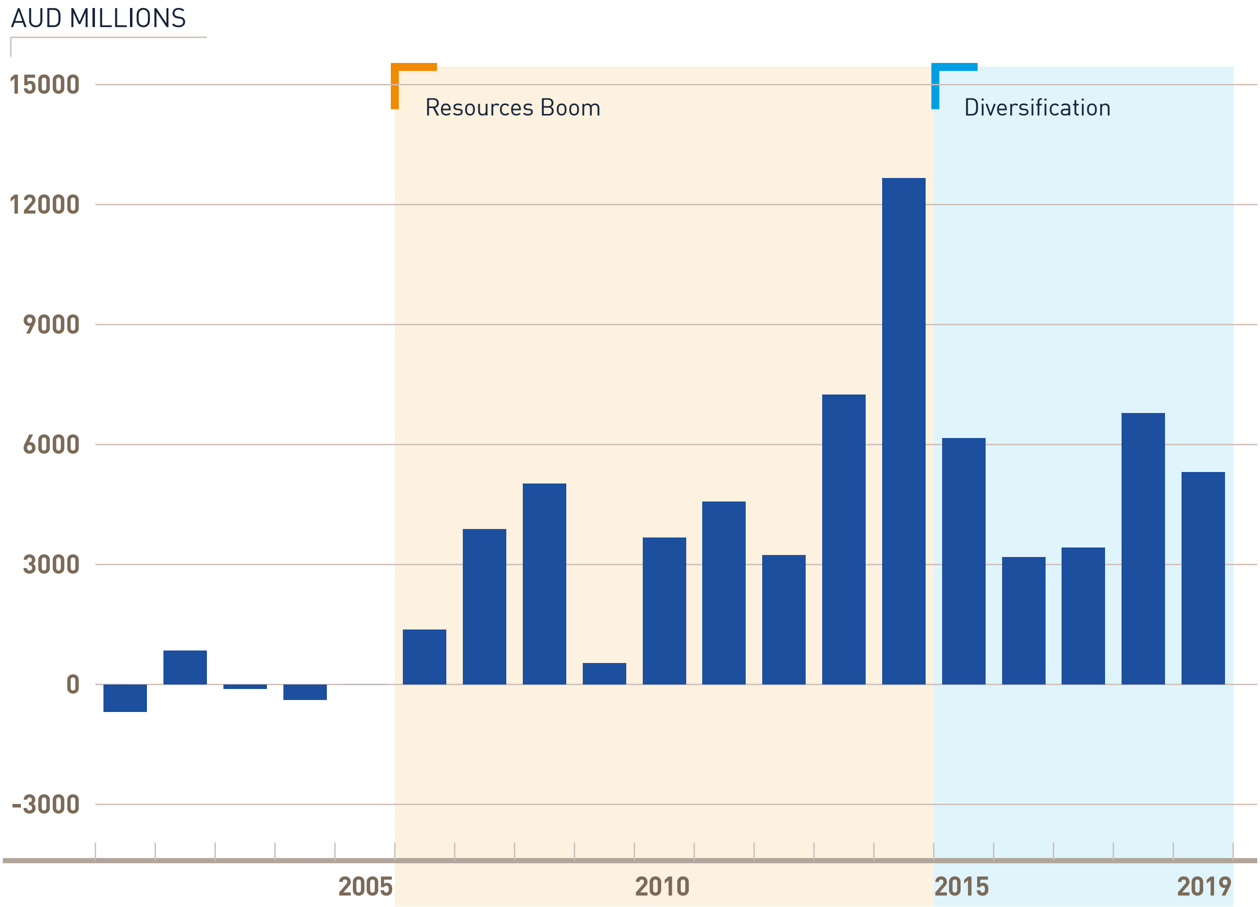
Managing China's emergence as an investor

The rise of China as an outbound investor has forced a reappraisal of Australian investment policy. For its entire modern history, the Australian economy has relied on capital inflows from 'traditional' partners – initially the UK, with the US and other European investors joining in the post-war years. The arrival of Japanese investors during the resources boom of the 1970s somewhat widened the base, but did not lead to an 'Asian reorientation' in investment ties similar to that seen in trade. It was a sudden uptick in Chinese investment in the mid-2000s that catalysed a rethink of Australia's investment outlook and policy settings.

The surge of Chinese investment was driven by both push and pull factors. On the push side, it was catalysed by an acceleration of China's 'Going Out' policy in 2004, under which SOEs were provided government support to internationalise through overseas acquisitions in strategic sectors[48]. On the pull side, Australia had emerged as a critically important mineral supplier, particularly for iron ore and metallurgical coal to feed China's rapidly expanding steel industry. As the mid-2000s resources boom drove the price of these minerals to record levels, Chinese industrial firms began investing in Australian mining projects[49]. From negligible levels, Chinese direct investment in Australia soared from 2006, before stabilising and diversifying into a broader range of sectors following the end of the resource boom (Figure 7).

Figure 7 **Chinese direct investment in Australia, 2001-19**



Source: ABS[50]. Note: Includes both PRC (mainland China) and Hong Kong investments, see note[51].

Chinese investment relationship posed new challenges for Australia's foreign investment regime. Chinese investment differs from that of Australia's traditional partners in two ways. First, it tends to come from SOEs, which are common across the Chinese economy and dominate the heavy industry and infrastructure sectors. Second, investments are often funded by state-owned banks, which offer so-called 'policy finance'[52] for projects selected by the government. These characteristics pose complex questions regarding the intent and implications of Chinese investment in Australia. Do Chinese firms adopt a commercial (i.e. profit-motivated) orientation to their investments, as with the private firms from traditional investment partners? Or do state-ownership and financing links mean the investors pursue strategic objectives on behalf of the Chinese government that are inimical to Australia's interests?

Never before had Australia needed to manage foreign investment from state-connected firms.

An initial controversy concerned the commercial orientation of Chinese SOEs. In January 2008, Chinalco – a state-owned aluminium producer – moved to prevent an attempted BHP takeover of Rio Tinto through a massive $15 billion 'dawn raid' on Rio's London-listed shares. Made with the backing of China's State Council, but without the approval of Australia's Foreign Investment Review Board (FIRB), the move was widely interpreted as a Chinese governmental intervention in an otherwise commercial matter[53]. The Chinalco raid caused significant consternation, and led to the issuing of an updated 'national interest test'. The new test added an additional principle by which the FIRB would review applications by SOEs, requiring that investments must conform to commercial principles (Box 2).

Box 2 **The Australian national interest test for foreign investment**

1. **National security** – potential impacts on Australia's ability to protect strategic and security interests
2. **Competition** – such as investors gaining control over global supply of an important product
3. **Other Australian government policies** – particularly but not exclusively with relation to taxation
4. **Impact on the economy and community** – including the prospects for investors to develop projects, and provide a 'fair return' to the Australian people
5. **Character of the investor** – whether there is transparency of commercial operations, and the quality of its regulatory supervision
6. **Foreign government investors and commerciality [added in 2008]** – whether the investment is commercial in nature, or pursues broader political objectives for the home government

Source: FIRB[54].

Overall, there is little evidence this reform seriously inhibited bilateral investment. Since 2008, the Australian government has declined only six major Chinese investment applications, none of which were due to the commerciality test55. However, Chinese parties consider it a discriminatory barrier. Surveys of Chinese firms consistently identify FIRB screening as a major obstacle[56], especially for SOE investors who must pass the commerciality test. For its part, the Chinese government made loosening FIRB rules a top priority in negotiations for the China-Australia Free Trade Agreement (ChAFTA)[57]. Australia agreed to Chinese requests to lower screening thresholds for private but not state-owned enterprises, which reportedly required that it drop market access requests for sugar and rice from FTA negotiations[58].

The launch of China's Belt and Road Initiative (BRI) in 2013 further complicated matters. The BRI aims to improve economic connectivity between China and its Indo-Pacific neighbours. Chinese SOEs provide investment, loans and construction contracts for infrastructure projects to regional partners. The BRI is an archetypal geoeconomic strategy. Economically, it aims to develop China's western provinces, encourage greater trade integration with contiguous partners, employ China's massive foreign currency reserves, and provide an outlet for surplus industrial capacity. Strategically, the BRI is designed to strengthen China's political influence abroad, secure China's energy supply, improve the country's diplomatic image, and increase its economic leverage over its neighbours[59]. Since 2014, China has channelled USD 274 billion of investment and construction contracts to Indo-Pacific countries under the BRI program (Figure 8).

Figure 8

Chinese investment and contracts in the Indo-Pacific, 2014-19

Source: AEI China Global Investment Tracker database[60]. Also see explanatory note[61].

Around the world, there has been a heated debate on how to balance the economic opportunities and strategic risks of the BRI. It principal strength is the channelling of significant volumes of capital – estimated potentially in excess of $1 trillion[62] – to developmentally-important infrastructure projects around the Indo-Pacific. For Australia, this is likely to open new trade and investment opportunities by improving transport and telecommunications links to key economic partners[63]. However, several concerns have been raised regarding the strategic implications of the BRI.

- Limited transparency in SOE-managed projects, which may undermine 'good governance' development financing[64]
- The prospect of debt burdens, in which small economies are unable to fiscally-sustain repayments on large infrastructure loans[65]
- Security concerns surrounding port projects with mixed civilian and military uses, particularly ports and digital technologies[66]
- Risks that 'chequebook diplomacy' will be used to compete for geopolitical influence over smaller economies

The Australian government has had to balance competing concerns in its response to the BRI. At times messaging has been positive, including the establishment of the Australia-China One Belt One Road Initiative (a business engagement NGO) in 2016[67], and official statements that Australia sees "*opportunities for collaboration*" in the BRI[68]. But Chinese approaches to formally establish intergovernmental mechanisms for infrastructure cooperation have been consistently rebuffed for strategic reasons. These include proposals to 'link' the BRI with the Northern Australia Infrastructure Fund, or to sign an MoU for BRI cooperation with the Chinese government[69]. Despite refusing formal links, the Commonwealth Government maintains that it will consider participation in BRI projects on a case-by-case basis[70].

On the domestic front, critical infrastructure has proven a significant BRI challenge. This infrastructure – assets important to Australia's defence, national security and/or social and economic stability[71] – poses unique policy challenges. While foreign investment makes an important contribution to Australia's infrastructure estate, there are concerns that allowing investment from Chinese enterprises with government links may compromise national security. Three high-profile cases illustrate these concerns:

- The 99-year lease of Darwin Port to Chinese company Landbridge in 2015 sparked controversy. The Northern Territory government was criticised for its failure to consider the implications of the lease for Australia's maritime and transport security[72].
- Chinese telecommunications company Huawei was prohibited from providing technology for both the National Broadband Network (2012) and the 5G network (2018)73. This was due to the risk of cyber-attacks and intelligence gathering on behalf of the Chinese government[74].
- The sale of NSW electricity distribution network Ausgrid to Chinese company State Grid was vetoed by the Treasurer in 2016. The Ausgrid network hosts infrastructure that is critical for the Australia-US Joint Defence Facility Pine Gap[75].

These cases elicited further reforms to the foreign investment regime. A Critical Infrastructure Centre was established in 2018, which provides specialist advice to the FIRB and identifies and manages risks facing critical infrastructure projects. A new 'national security test' was also added in 2020[76]. This upgraded the regulatory approvals required for foreign investment in a 'sensitive national security business', and greatly increased compliance and monitoring powers. While official statements described these changes as 'country agnostic'[77], they were widely understood to be a defensive measure against security risks posed by Chinese investments in critical infrastructure[78].

Australia's refusal to formally engage with the BRI has been a major source of political contention.

A significant number of businesses are in favour of engaging with the BRI, lest Australia is excluded from the new market opportunities in the region it is creating[79]. Concerns have also been raised regarding the way that new critical infrastructure rules reduce investor certainty (for both Chinese and non-Chinese firms); and may close off access to Chinese sources of investment[80]. For its part, the Chinese government has sought to convince Australian states to break with the Commonwealth and sign their own sub-national BRI MoUs. Such efforts were directed at Victoria[81] and Western Australia[82], with the former successful in 2018. This led to suggestions that China was attempting to foment splits within the Australian federal system. The Prime Minister has declared Victoria's BRI MoU is against Australia's national interest[83], and in 2020 announced a review of all international agreements by subnational bodies[84].

Internationally, China's BRI investments in the Pacific Islands has been a source of concern for Australia. While the Pacific is only a minor focus in the overall BRI program (Figure 8), these investments have a significant effect in these small economies. Australia has long been the biggest foreign investor and provider of aid in the Pacific Islands, and has identified a number of strategic concerns. One is the risk of indebtedness, where small Pacific governments are unable to fiscally sustain large infrastructure loans[85]. Another is that China may leverage its investment in infrastructure through the dual-use of ports to establish military bases, such as the Chinese-built wharf on Espiritu Island in Vanuatu[86]. Risk have also been reported to the security of digital infrastructure, including for datacentres and undersea internet cables[87]. In 2018, the Foreign Minister publicly expressed concern that BRI investments in the Pacific would be *"detrimental to [these countries'] long-term sovereignty"*[88].

Australia responded to these risks with the 'Pacific Step Up' program, announced in the 2017 Foreign Policy White Paper. The Pacific Step Up program prioritises the region in Australia's foreign policy, with a stated objective of ensuring the 'sovereignty, stability, security and prosperity' in the region'[89]. It also established the $2 billion Australian Infrastructure Financing Facility for the Pacific (AIFFP) to support infrastructure projects in Pacific island countries[90]. In 2019, Australia's also announced it would cover two-thirds of the cost to build an undersea internet cable from the Australian mainland to the Solomon Islands. It was widely reported that this move was made in order to displace a proposal by Huawei, which had been previously excluded from Australia's digital infrastructure on security grounds[91].

Australia is now engaged in direct competition with China's infrastructure diplomacy.

The challenge posed by Chinese investment in Australia stems from the fundamental differences between economic systems. The dominance of SOEs in the Chinese economy – and their corresponding role in advancing policy mandates – clashes with Australia's predominantly private corporate system. Australia's liberal investment policy settings are not suited to managing risks associated with state-owned investors, either within Australia or in the region. Domestically, Australia has repeatedly tightened its foreign investment regime and refused formal linkages with the BRI, both of which have managed these strategic risks at the economic cost of erecting barriers to Chinese investment. In the region, Australia has been drawn into direct competition with the BRI, a trajectory that augurs poorly for bilateral economic relations. Australia's liberal approach to foreign investment thus puts it at a decisive disadvantage when responding to the surge of geoeconomically-driven investment from Chinese SOEs.