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A natural power

Challenges for Australia's resources diplomacy in Asia

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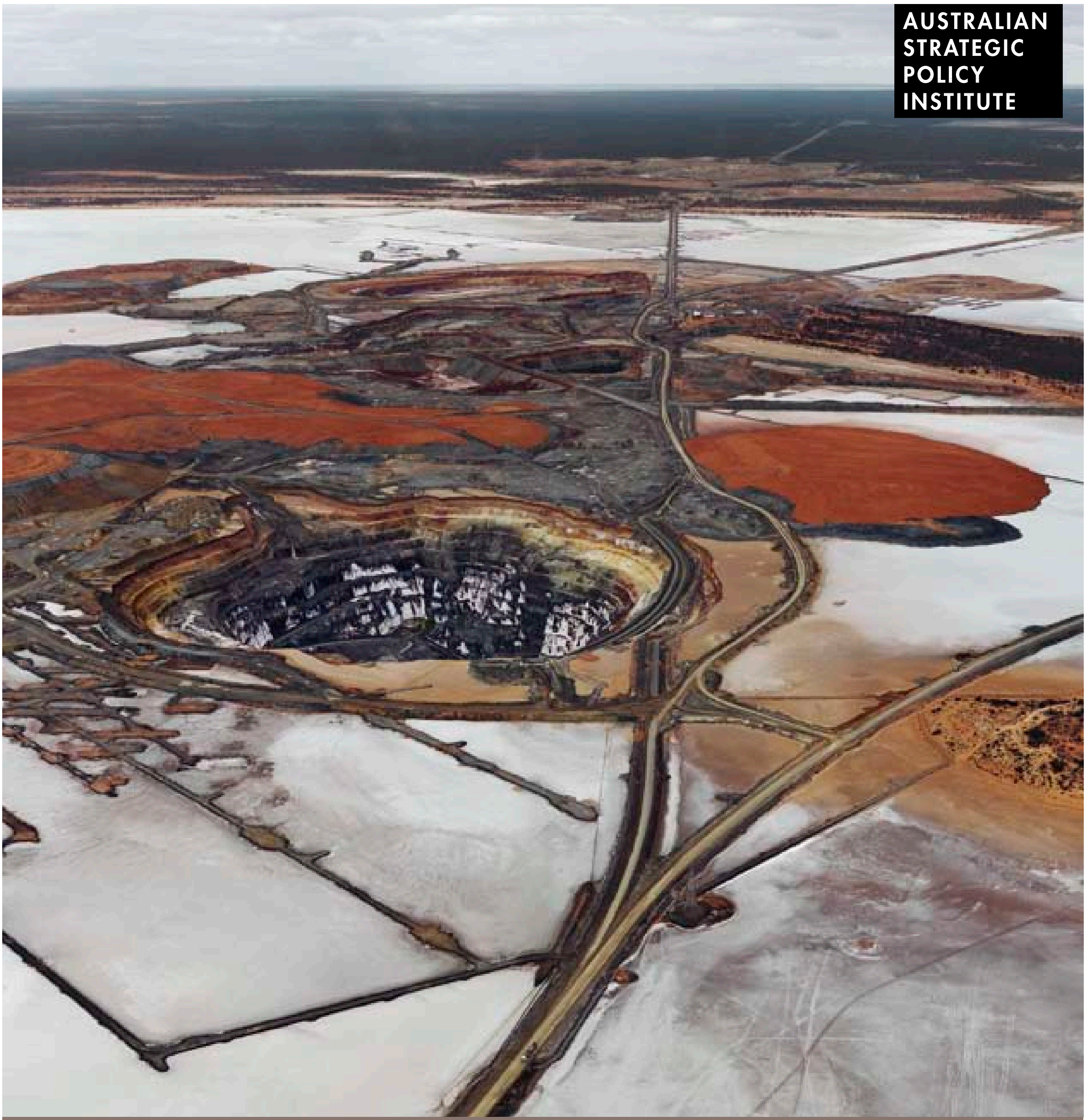

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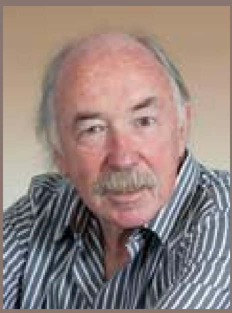

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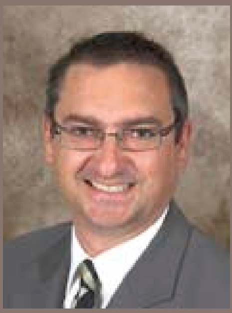

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Cover image: Silver Lake Operations # 2, Lake Lefroy, Western Australia, 2007. Photograph by Edward Burtynsky. Image courtesy Hasted Hunt Kraeutler Gallery, New York & Nicholas Metivier Gallery, Toronto.

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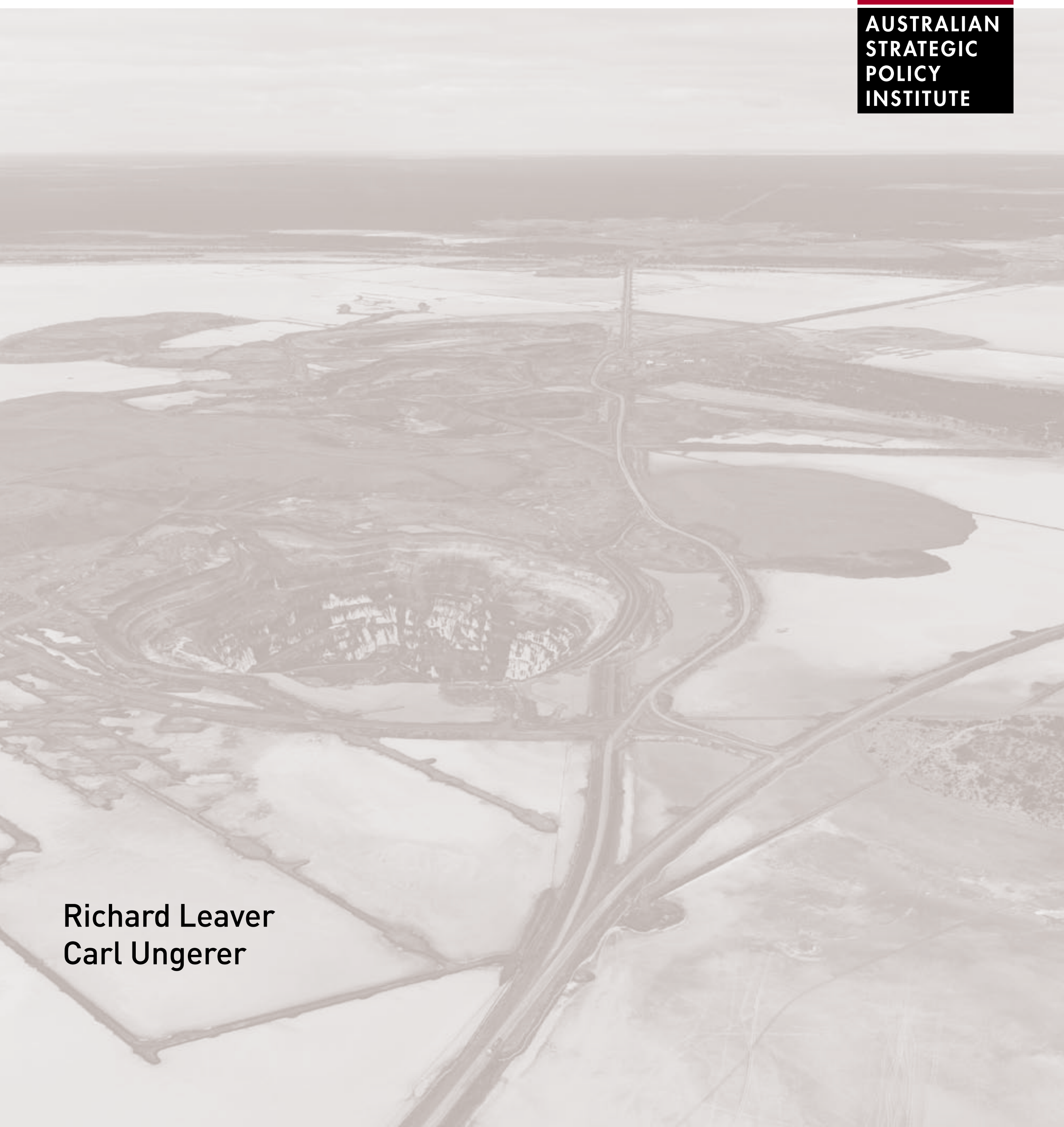

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Contents

Executive Director's introduction 1

Executive summary 3

Chapter 1
Introduction: resources and security 5

Chapter 2
China and iron ore 11

Chapter 3
India and uranium 25

Chapter 4
Reducing the risks 35

Endnotes 39

Acronyms and abbreviations 41

References 42

Executive Director's introduction

Australia's national interests, both strategic and economic, are tied to the future of Asia. As the shift in global power moves inexorably towards this part of the world, Australia will face a number of challenges in our efforts to promote greater regional security and prosperity.

More so than many other countries, Australia is well placed to confront these challenges head-on and to prosper in uncertain times. Australia's natural resource base places it among the first rank of powers in the global competition for energy and resource security. Australia is one of the world's largest producers of iron ore, and has the largest known reserves of low-cost uranium. Together, these two commodities will play an increasingly important role in regional economic development and the strategic relationships among the Asian major powers.

In recent years, resources diplomacy has been an underdeveloped concept in Australia's strategic posture. Although previous governments have, on occasions, attempted to link our natural resource base to broader foreign and security policy outcomes, this has not been done in any systematic or sustained way. As a country committed to free market principles, the idea of 'natural power' has not been at the centre of the national political debate.

But, as this report argues, the growing intersection between economic considerations, national security and environmental considerations compels governments to re-examine their diplomatic toolkit and to employ the instruments of national power in new and potentially novel ways.

Through the analysis of two specific case studies—iron ore in China and uranium in India—this report examines some of the diplomatic opportunities available to Australia that flow from its position as a world leader in natural resource exports. Resources will be a fundamental part of our broader bilateral relationships with China and India as they mature.

Photo opposite: Silver Lake Operations # 6, Lake Lefroy, Western Australia, 2007. Photograph by Edward Burtynsky. Image courtesy Hasted Hunt Kraeutler Gallery, New York & Nicholas Metivier Gallery, Toronto.

Not everyone will agree with the conclusions reached in this paper, but there's no doubt that our natural resources will be at the centre of Australia's Asian engagement strategy well into the future.

I am grateful to the two authors for writing this interesting and challenging paper. I would also like to thank the external reviewers and the many government and industry officials who shared their views with the authors during the preparation of this report.

As with two earlier *Strategy* reports on China, ASPI has again used the beautiful photographic images of Canadian photographer, Edward Burtynsky. The transformation of nature through industry is a prominent theme of Burtynsky's work.

Peter Abigail
Executive Director

Executive summary

A decade ago, around the time of the Asian financial crisis, the place of natural resources in the contemporary international agenda had fallen to an all-time low. Today, however, things have changed dramatically. Natural resource politics is reasserting its importance around the world.

The return of resource politics is associated with three global developments: the economic rise and growing strategic weight of the Asian major powers (China and India), which are growing consumers of raw materials and sometimes big producers as well; the increasing interconnection between trade, national security and environmental considerations; and the imperative to achieve increasing levels of national economic prosperity at a time of uncertain global markets. Each of these developments holds important implications for the form and conduct of Australian bilateral diplomacy.

China, armed with sovereign wealth funds and instructions to 'go out', seems intent on building up its base of natural resources through either foreign purchasing or foreign investment. Recent Chinese investments in Australia's iron ore and natural gas industries are just one small part of Beijing's global resources strategy.

India's appetite for raw materials, including uranium, is potentially no less voracious. Other countries in Asia, such as Japan and South Korea, are in a similar position. For these countries, there is no question that the international politics of natural resources is a matter of high strategic importance.

Traditionally, resources diplomacy has been understood in Australia only from the demand side, as the diplomatic pressure that consumer nations bring to the task of securing the natural resources they need for long-term economic security. But there's an important supply-side element to resources diplomacy as well. It's about using the supply of key commodities as part of a broader set of national instruments to chase export opportunities and to strengthen key strategic relationships.

This theme has waxed and waned in Australian diplomacy for several decades. But despite its enviable position, Australia has not sought to assert its influence on key commodity markets or to leverage our commodity exports for broader national interest calculations in any consistent way. Given the current importance of energy and resource security, can we now use our existing resource base to support broader foreign and strategic policy goals? In what ways can commodities be used to achieve diplomatic outcomes? And does size bring influence?

In answering these questions, this paper outlines some of the history and practice of Australia's resource diplomacy. It focuses on the two commodities that, at different points over the last century, have had no trouble justifying the label of 'strategic resource'—iron ore and uranium. And it identifies some specific avenues for Australia to incorporate resources diplomacy more closely into national policy.

A central theme is that Australia's role as a stable, low-cost supplier of key commodities gives it a greater diplomatic bargaining tool than previous governments have been willing to acknowledge.

The paper outlines four broad policy recommendations to enable Australia to fully exploit its international position as a 'natural power':

- a reassessment of the idea that commodity marketing is a commercial issue that should be governed solely by commercial agents without state involvement
- raising the current discussion with Beijing on free trade issues into a bilateral 'strategic economic dialogue' that aims to produce acceptable principles for competition and foreign investment policy
- broadening that dialogue into a global campaign directed against speculation in commodity markets, and
- deepening our strategic partnership with India through the direct sale of uranium.

Chapter 1

INTRODUCTION: RESOURCES AND SECURITY

A decade ago, at the end of the Asian financial crisis, the place of natural resources on the international agenda had fallen to an all-time low. The price of oil plumbed new depths of just US$10 per barrel in early 1999. In Australia and elsewhere, debates about the pathways for future growth focused on the growing importance of 'the new economy', in which interactions between the information technology and financial services sectors held sway.

Today, circumstances have changed dramatically, not least because of the bursting of the bubbles that built up around those two sectors that once seemed to define the future. In the aftermath of the global financial crisis (GFC), resource politics is reasserting its diplomatic and strategic importance around the world.

The return of resource politics is associated with three critical global developments:

- the economic ascent and growing strategic weight of the Asian great powers, China and India, which are rising consumers of raw materials (and occasionally big producers as well)
- the increasing interconnection between trade, security and environmental considerations
- the imperative to achieve greater national prosperity at a time of contracting international markets.

Each of these developments holds important implications for the form and conduct of Australian diplomacy.

China, armed with sovereign wealth funds (state-owned investment funds) and instructions to 'go out', seems intent on building a worldwide base of natural resources through either foreign purchase or foreign investment. Chinalco's failed 2009 bid for a larger stake in Rio Tinto—the largest-ever overseas investment proposed by any

Chinese company—is the most spectacular example of this trend, but it's by no means the only one. In the month that Chinalco made its $30 billion offer, more than $10 billion of other Chinese-origin foreign investment proposals were placed before the Australian Government.

And the same trend is evident overseas—most notably in Africa, where Chinese interests now run to much more than oil. India's appetite for raw materials is potentially no less voracious, although it isn't yet clear that sufficient funds exist to satisfy that demand by foreign direct investment.

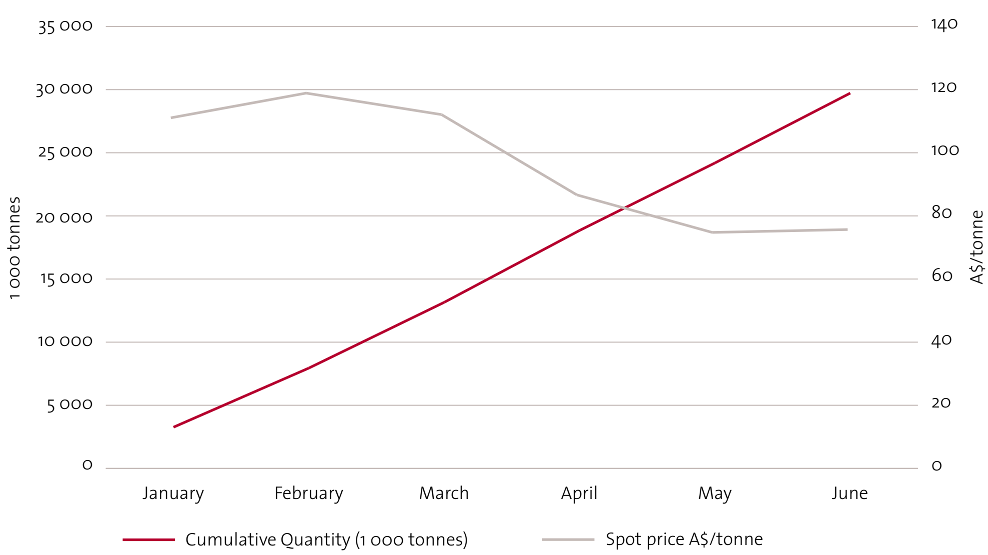
Other countries in Asia have been in similar positions for longer periods. During the postwar period, Japan and South Korea quickly became accustomed to sourcing almost the complete range of industrial raw materials offshore, using long-term purchasing contracts as their main supply instrument. For these consumer nations, there has never been any question that the international politics of natural resources is a matter of high strategic importance.

There's nothing inevitable about the commingling of trade, security and environmental considerations that makes up the second key global trend.

There's nothing inevitable about the commingling of trade, security and environmental considerations that makes up the second key global trend. But when nations increasingly pursue progress on trade liberalisation bilaterally rather than multilaterally, the three concerns are often dealt with casually, rather than as part of more formal relationships between nations.

Australia's diplomatic push to hedge its bets in its dealings with the Asian great powers is a case in point. The hedging began in earnest in August 2004, when the then foreign minister, Alexander Downer, travelled to Beijing to argue that Australian strategic policy in East Asia

Figure 1: Chinese imports of iron ore by volume 2009



Source: China Mining Association

was not, in all circumstances, precommitted to Washington's ends. As a sweetener, he took with him a Cabinet commitment to begin talks about a bilateral free trade agreement. In return, he brought home the secret knowledge that Beijing wanted to buy Australian uranium for its expanding civil nuclear energy program. This began the close association between trade, security and environmental issues that became emblematic of the Asia diplomacy of the fourth Howard Government. And there's little doubt that a fifth Howard term would have seen the extension of these kinds of linkages to India.

The Rudd Labor Government has reconstituted the issue-linkage formula. From the beginning, it was clear that the new government wasn't going to do anything with India that might compromise the Nuclear Non-Proliferation Treaty (NPT), partly because it wanted to buttress the treaty's standing during the run-up to its 2010 review conference.

Although that position initially seemed to be connected more to unresolved defence debates than to the GFC, it was followed by the outline of a broader conceptualisation of national security. In his parliamentary National Security Statement of December 2008, Prime Minister Kevin Rudd listed economic prosperity, the environment and energy security as high national priorities. Immediately after the statement, the government began to pay progressively more attention to insulating the domestic economy from the ravages of the GFC. More than $50 billion of stimulation policies were committed in two tranches over the following months.

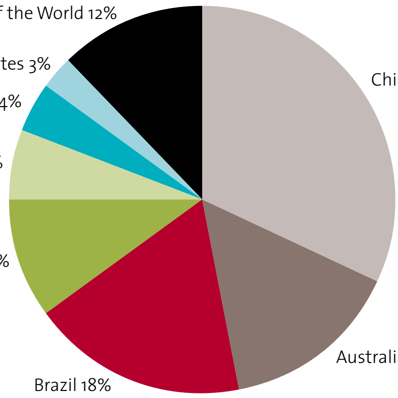
The third key global trend—achieving national prosperity in a contracting international market—concerns the way states respond to the GFC. Although many developed countries have made commitments to keep international markets open, the fact that the bottom of the recession still can't be predicted with any certainty wipes much of the face value off well-intentioned words. No common path for policy has been defined clearly at the Group of 20 level, so it's highly likely that policy responses to the crisis will mainly take shape at the national level, with local prosperity being seen as the most important goal in declining markets. In Australia, for example, concepts not heard of in government circles for a very long time (most notably 'nation building') have begun to course through economic debates, while industry policy has grabbed hold of large swathes of the trade agenda.

… there's an important supply-side element to resources diplomacy as well, and it's often overlooked.

Traditionally, resources diplomacy has been understood in Australia only from the demand side, as the diplomatic pressure that consumer nations bring to the task of securing the natural resources they need for long-term economic security. But there's an important supply-side element to resources diplomacy as well, and it's often overlooked. It's about using the supply of key commodities as part of a broader set of national instruments to chase export opportunities and to strengthen strategic relationships.

This theme has waxed and waned in Australian diplomacy for several decades. There was a muted discussion of resources diplomacy during the Gorton and Whitlam governments. The debate, such as it was, stepped off from public concern about 'selling off the farm' and evolved into one about the terms and conditions that should govern raw materials exports.[1]

Figure 2: Global distribution of iron ore production, 2006



Source: Data from British Geological Survey (http://www.bgs.ac.uk)

Uranium aside, very little of that debate could now be regarded as active. Australia has become perhaps the largest non-oil commodity exporter in the global economy. It's been the largest exporter of coal for several decades and has recently re-emerged as the largest iron ore exporter (while easing back to third rank in uranium). And commodities, especially bulk commodities, have acquired an unprecedented presence in Australia's export profile. Although many consumer nations would envy these positions, Australia has not generally or consistently sought to assert its influence on key commodity markets or to leverage its commodity exports into broader calculations of national interest.

Table 1: Australian uranium: production and export volumes and values

	2004–05	2005–06	2006–07	2007–08	2008–09 (estimate)	2009–10 (forecast)
Uranium oxide production (t)	10,964	9,974	9,594	10,101	10,130	10,590
Uranium oxide exports (t)	11,249	10,253	9,519	10,139	9,820	10,590
Uranium oxide export value ($m)	475	546	660	887	903	1,070

Source: Australian Bureau of Agricultural and Resource Economics (ABARE).

However, the question of how we might use our existing resources to support broader foreign policy and strategic goals has emerged quietly in recent years. For example, former Prime Minister John Howard occasionally talked about Australia's potential to become an 'energy superpower'.[2] In earlier times, Labor foreign minister Gareth Evans used to talk about the political 'clout' that Australia could extract from its safeguarded uranium sales in the international market. In neither case was the leverage mechanism of the energy and uranium projects spelled out, so questions linger: in what ways might natural commodities be used to achieve diplomatic goals? And does size really bring influence?

This paper attempts to answer those questions. It focuses on two commodities that have undoubtedly been 'strategic' resources at different times over the past century—iron ore and uranium. The paper then identifies some specific ways that Australia could incorporate resources diplomacy more closely into the mix of national policy.

The main findings of the analysis can be stated up front. Australia's role as a stable, low-cost supplier of key commodities gives it greater diplomatic leverage than governments have generally wanted to acknowledge.

The key to unlocking this potential isn't size so much as self-restraint. When large producers are able to accommodate the interests of smaller ones, orderly conditions can be created inside commodity markets. There's potential to use Australian uranium sales, including sales to India, to promote broader strategic conceptions of a more secure nonproliferation regime. And we now have the opportunity to bring the various strands of national policy closer together, perhaps around the unifying theme of national economic security.

… Australia's diplomacy towards Beijing has been complicated by the organisational chaos on both sides of the market.

Using iron ore sales in the same way is more difficult because normal commercial transactions in that market have always been uncomfortably close to all-out trade warfare. In the aftermath of the Chinalco affair, Australia's diplomacy towards Beijing has been complicated by the organisational chaos on both sides of the market. At the same time, the external balance of the Australian economy increasingly rests on exports to China, and 60% of revenue from that trade comes from iron ore. Past pretences about 'normal commercial relations' have therefore outlived their use-by date, and any post-GFC return to a more stable market will require a more active role by the Australian Government. To that end, this paper takes a spanner from the American toolbox of diplomatic instruments and suggests the establishment of a bilateral strategic economic dialogue between Canberra and Beijing.

Table 2: Australia's commodities

	Iron Ore	Uranium
Export volume 2008–2009	324Mt	10114kt
Value of exports A$million 2008–2009	34239	990
Average spot price 2007–2008	69.7 A$/t	80.75 US$/lb
Reserves	23.9Gt	1062kt
Australian reserves as percent of world EDR	15.13%	34.84%
World ranking in terms of export volume, 2008	2	2
World ranking in terms of export volume, 2009	1	3

EDR = economic demonstrated reserves

Sources: Export volume, value and spot prices: ABARE, Australian commodities, *March Quarter, vol. 17, no. 1, 2010. Reserves: demonstrated EDR at 31 December 2008, Geoscience Australia, 2009.*

Strategic commodities

Whether a commodity is ‘strategic’ hinges on the meaning of ‘strategy’. In a substantive sense, commodities acquire strategic significance insofar as they affect the military potential of the state. Since no commodity has only military uses, that definition highlights the problem of ‘dual use’. For example, although there’s an important civil use for uranium as reactor fuel, its potential to contribute to a nuclear weapons program inevitably makes it a strategic commodity.

Sometimes competing civil and military demand can become intense because of the absolute scarcity of a commodity. In that case, a state might implement a policy of strategic purchasing and stockpiling to cover future military needs in advance—as happened with uranium in the early Cold War years. Similarly, most states keep a close watching brief over the potential needs of their military for oil and oil products, and have contingency plans to prioritise their consumption in a crisis.

So the simple definition of ‘strategic resources’ has considerable strengths, but also two weaknesses. First, the overall context is important in drawing the dividing line between strategic and nonstrategic commodities. In times of war, commodities not normally regarded as strategic can suddenly appear to become so, sometimes with great moment. For example, during the early Cold War, a very broad conception of economic warfare guided US policy on trade with the major communist powers, including trade in foodstuffs and natural resources.[3] But should we really regard wheat, for instance, as a strategic commodity just because one important government once happened to say so?

The second weakness concerns the issue of ‘guns versus butter’. The basic argument here is that efficiencies in the production of civilian goods, including goods with no direct military value, will liberate economic resources that can then be redeployed to increase military strength. The argument can be run in reverse, which is precisely what much of the debate about economic sanctions does: it’s argued that civil sector inefficiencies, including ones externally imposed through commercial sanctions, exact a price in the form of reduced military output. This line of argument, in either direction, commonly gets a hostile reception from the proponents of free trade. However, it’s really an extension of free market thinking to the military sector (which free marketeers normally assume doesn’t exist).

These two weaknesses suggest that there’s virtue in an alternative definition of ‘strategic’ that pays attention to the rules of the game. By this account, strategy is an interactive game where a successful outcome can’t be guaranteed in advance of other players’ responses. This more formal definition fits very neatly with the international trade in iron ore precisely because the General Agreement on Tariffs and Trade and the World Trade Organization have never covered raw materials. Add to this the fact that the iron ore market is heavily concentrated on both the supply and the demand side, and that state agencies cast a large shadow over both, and there are sound reasons for regarding trade in iron ore as having strategic qualities.

Chapter 2

CHINA AND IRON ORE

Like governments everywhere, Canberra was once strongly influenced by arguments about iron ore's strategic value. During the lead-up to World War II, there were deep concerns about the adequacy of Australia's natural resources base for steel production. Iron ore supplies had previously been tight, with the Middleback Ranges in South Australia as the main national source, and fears of future shortages loomed large. If there was a bright side, it was that Japan's natural resource endowment was even worse, but Tokyo's attempt to improve its lot by colonisation showed that it wasn't willing to live with permanent inferiority.

With recent plans for defence-related industrialisation near the forefront of calculations, Canberra moved in May 1938 to impose an embargo on iron ore exports—thereby shutting out a Japanese attempt to take equity in the Yampi Sound iron ore deposit in Western Australia.[4] The embargo was multilateral in form, but, because Japan would have been locked in as the only buyer for this ore, the policy was considerably more targeted than appearances suggested.

In the event, the export embargo not only survived the military defeat of Japan, but lasted a further decade and a half. It was partially lifted in 1960 after the Western Australian Government managed to convince a more sceptical Commonwealth that future iron ore resources were considerably larger than previously known. The argument from Perth proved remarkably prescient—soon after, huge iron ore discoveries in the neglected Pilbara region were made public by the now-legendary Lang Hancock.

Inside two decades, the Hamersley Iron Province had multiplied known Australian reserves by more than a hundred.[5] Iron ore output expanded twentyfold, placing Australia third in production behind the two Cold War superpowers and, briefly, first in export volumes.

At first appearances, it might have seemed that Australian governments after 1960 were reaching for the strategic whip hand that they'd presumed they held in the late 1930s, and that local endowments of iron ore could be swung behind national diplomacy. However, the main resource diplomacy gambits in the iron ore market at the time came from the consumer side of the market, where Japan was the main player. Australians expected 'clout', but they were about to get clouted.

The initial development of the Pilbara province reveals a particularly inventive Japanese approach to bargaining—and, conversely, the lack of even a mildly coordinated Australian approach. The deal that brought the original Hamersley deposit into production was necessarily complex—multilateral bargaining simultaneously involved contending mining consortiums, Japanese steel mills and potential financiers with all levels of Australian government.[6] Importantly, the long term sales contracts that came out of this bargaining obviated the need for high levels of Japanese investment in Australia's new iron ore industry—a politically convenient outcome for both Tokyo and Canberra.

Many Australians initially thought that their dominant raw materials position would give the country substantial influence over international developments in steel production and industrialisation in general.

Many Australians initially thought that their dominant raw materials position would give the country substantial influence over international developments in steel production and industrialisation in general. But Australia's steel industry fell away more or less at the same time as iron ore exports exploded. Later, the discovery of impressive volumes of natural gas in offshore areas adjacent to the Pilbara led state and federal governments, under the rubric of the Pilbara Study Group, to momentarily dream about bringing these raw materials together to create a regional node of steel-based industrialisation.

By that time, however, falling raw materials prices had devalued the advantage of proximity that once accrued to countries apparently blessed with an abundance of raw materials. The composite result was a serious national matter, well captured with heavy irony a few years later by Stuart Harris (1975), who went on to oversee the merger of Foreign Affairs and Trade, and who commented that the Japanese:

> … must be admired for their ability to convince Australians that they can choose when, where and how to purchase their mineral needs and to panic many politicians and commentators so that, in what is essentially a seller's market in the long term, the importers appear as uninterested buyers and Australians look like vendors in a disposal sale.

In its characteristic sardonic style, *The Economist* had reached the same general conclusion some years earlier: 'Beggars cannot be choosers, unless of course they are Japanese'.[7]

The rise of China: the vendors' revenge

By the end of the 1970s, the surge of production in the Pilbara had positioned Australia just below the US, previously the leading iron ore producer of the non-Communist world but now a declining force. At that time, Australian production was still some 20% greater than that of China, which was just entering the first stages of domestic liberalisation. No-one saw it coming then, but another quarter century of outward turning would make China a larger importer of iron ore than Japan—and therefore a market of fundamental significance to the Australian industry.

The first difference was the pace of China's transformation. In 1995, the East Asia Analytical Unit in the Department of Foreign Affairs and Trade made a comparative study of the Australian and Chinese iron and steel industries, and claimed that Australia's iron ore exports would grow by 150% over the next decade (EAAU 1995). The unit was never known for predictive modesty, but that prophecy proved massively short of the mark. When the figures for Australian exports in 2005 arrived, iron ore had grown by another 150% on top of the 1995 forecast. The main engine of this massive spurt—more rapid, indeed, than during the period up to 1980—was the demand coming out of China's steel industry. Along the way, China passed Japan to become the largest importer of iron ore in 2003. This time, the new number one did not slow down; five years later, the gap between Chinese and Japanese imports had blown out to nearly three to one.

The second difference was that China was usually the world's leading producer of iron ore as well as its leading importer. Even when Beijing's official figures are deflated to allow for the low quality of much domestic production, China ranks in the company of Brazil as a producer state. This puts China in a completely different league from all of Australia's other Asian customers for iron ore, none of which have substantial domestic production capacity.

Third, the domestic structure of China's iron and steel industry, including its raw materials suppliers, is highly decentralised.[8] This often comes as a great shock to those who like to think of China as the last of the centrally planned economies, but planning primarily manifests itself at the local rather than the national level. Of course, China has big and politically powerful steel producers, but their domestic dominance doesn't begin to rival that of the leading Japanese producer. Consequently, although China manufactures more than 35% of global steel, it hosts only one of the world's five largest steel companies.

These decentralised trends inside the world's largest market—China was taking nearly 50% of internationally traded iron ore by 2007—have come to contrast markedly with centralising trends on the supply side. Overall, allowing for setbacks during recessions, the rise of Australian production has continued at an impressive pace. However, that achievement has been easily exceeded by Brazilian production, also primarily for export, from the parastatal company Companhia Vale do Rio Doce (CVRD), privatised in 1997 and rebadged as Vale a decade later.

As in Brazil, mergers and acquisitions in Australia have increased concentration on the supply side, while simultaneously establishing Rio Tinto and BHP Billiton as the world's second- and third-largest iron ore companies. At the same time, rising prices always threaten to bring forward new sources of supply that might eventually cause the collapse of concentration—although potential new mines also provide good targets for acquisition by the established giants.

The Japanese had always maintained an impressive unity on the demand side by pooling their purchasing power. In contrast, in the relatively short period since China became the largest purchaser, the decentralised nature of the Chinese steel industry has eroded unity on the demand side. In combination with a particularly rapid escalation in Chinese demand for steel after 2003—driven mainly by the combination of urban and Olympic construction—falling demand-side concentration tilted bargaining power back in favour of producers. The moment for the revenge of the vendors had arrived, and an 'iron war' began to manifest itself through a sequence of vigorous price rises.

Those increases go back to the end of 2002, when the world economy was beginning to recover from the onset of the global war on terror. However, they only really impinged on public consciousness in 2005 when Nippon Steel, the leading Japanese producer, precipitately agreed to a 50% increase in the benchmark price—a very dramatic departure from all previous experience. Although that rise seemed to be in line with the expectations of China's steel industry, it claimed to be enraged over the lack of consultation.

That objection missed the more important fact that Australian iron ore exports to China had soared by 40% over the previous twelve months, to twice the current requirements of China's steel industry, with the excess headed for stockpiles. China's steel producers were therefore in no position to exert downward pressure on prices, and they soon exceeded Nippon Steel's achievement by settling for a price increase of 71.5% with Rio Tinto and CVRD. Domestic fragmentation was denying the Chinese the negotiating clout that their size appeared to warrant.

There were few celebrations in Beijing; indeed, central authorities showed signs of alarm, and Chinese Premier Wen Jiabao talked up the need for direct and forceful countermeasures. Ideas about market intervention, price caps, import caps and a simple refusal to accept any further price rises all swirled around. Soon, a more centralised licensing system for iron ore imports was imposed, reducing the number of importers by 80%, but that still left more than a hundred licence holders and probably had only minimal effect. On the sidelines, talks about an Australia–China free trade agreement were commencing, and the Howard Government had already rather casually offered Beijing status as a market economy. This may have helped sweeten the atmosphere for the price increase, which was estimated to add 2% to Australia's gross national product.

In 2006, with China positioned as the largest market for the Australian miners, further price rises of 10% to 20% were widely expected. Despite these more modest proportions, reports suggested that the negotiations were the most acrimonious in years. The source of angst appeared to lie inside the Chinese steel industry, where profits had declined by 70% despite a 16% rise in production and a price increase twice as large again. In combination with general negotiating inexperience, these cross-pressures induced China's negotiators to express their dominance by 'leading from behind'—a venerable Japanese theme, but one never practised in raw materials. So the Europeans, the Japanese, the Koreans and the Taiwanese all completed their price deals before, eventually, the Chinese industry accepted the trend of a 19% rise. This tactic wasn't repeated in 2007, when the Chinese got out in front of negotiations very early, doing a trendsetting deal within six months of the 2006 cave-in. Baosteel, which now represented more than two hundred other mills, agreed on a 9.5% price rise with CVRD before Christmas, and the heat from the previous year dissipated (Wyatt 2006).

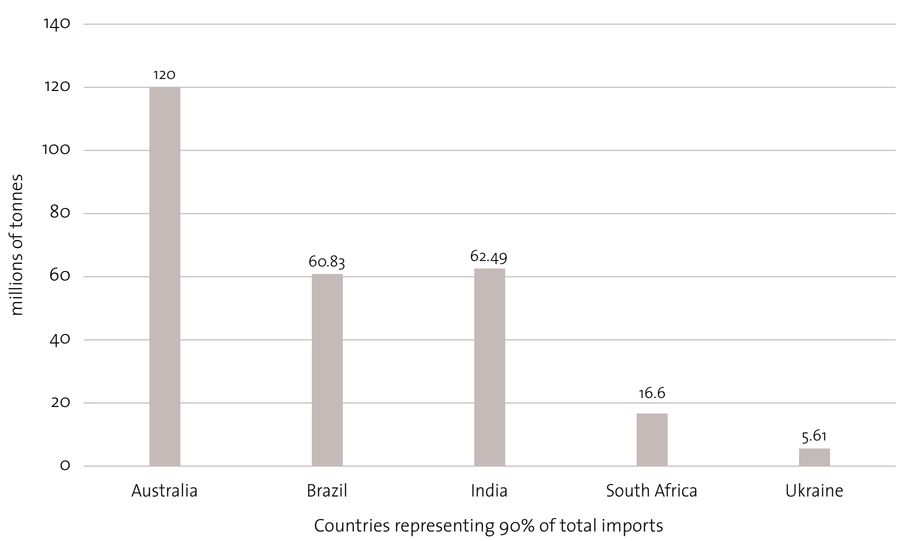
The Chinese had always regarded the record increases of 2005 as blackmail, and made it clear that there would be no repetition. But in 2008, that result from the last year of Japanese price dominance was bettered, especially by the Australian companies. As usual, Vale (as CVRD had been renamed) led the process off, negotiating an increase on par with 2005. It was bargaining with the South Koreans and the Japanese, who had joined forces in order to beat Baosteel to the line. The Australian producers brought up the rear in a tight market, and held out for an additional premium to reflect their lower freight costs. For their prime products, the realised price rise was just under 100%. In a further aggressive move consistent with its approach to other raw materials markets at that time, BHP Billiton began talking about shifting a larger proportion of its product out of contract markets and through the spot market, where small volumes had for some years yielded prices that were another 100% greater still. Indexed prices were, it said, its real aim.

Australia's close economic relationship with the fast-growing Chinese economy was initially held out as a saviour of the resources sector—if not, indeed, of the whole national economy.

The 2008 price rises helped the new Rudd Government realise an important national objective. Strong Australian growth since the Asian financial crisis had previously yielded an unbroken string of trade deficits. But by late 2008, higher iron ore and coal prices were finally delivering a small series of monthly trade surpluses. A significant number of Labor's senior ministers had come to office in search of improved trade figures, and some, including Rudd himself, would go on to champion broader notions of economic security.

These themes were made more pertinent by the threat of hard times coming out of the sub-prime financial crisis. Australia's close economic relationship with the fast-growing

Figure 3: Chinese iron ore imports January to June 2009



Source: China Mining Association

Chinese economy was initially held out as a saviour of the resources sector—if not, indeed, of the whole national economy. Although price falls would be coming, the material basis for a closer relationship between Australia and China appeared to be falling into place.

From prices to principles

What wasn't so productive of harmony, however, was the sequence of proposed mergers and acquisitions that swept across the Pilbara region. To date, the sequence has unfolded in three stages: BHP's November 2007 takeover bid for Rio Tinto, which was abandoned a year later; the Chinalco attempt of February 2009 to construct a strategic alliance with Rio Tinto, which fell apart the following June; and the proposal for a joint venture between Rio and BHP that will only cover their mining operations in the Pilbara. These developments soon raised awkward questions in Canberra and Beijing about the status of Australia's policies on competition and foreign investment—questions that threatened to overwhelm the significance of pricing.

Given its status as the world's leading mining company, BHP had never been comfortable with its secondary position in the Pilbara. All its chief executives during the previous decade had explored the possibility of a friendly merger with Rio, but in late 2006 BHP's board began thinking about a hostile takeover. They appointed a new CEO—Marius Kloppers, the executive who had led their successful acquisition of WMC Resources Ltd in 2005. Despite a purchase price that was thought excessive at the time, Kloppers had been instantly rewarded with rising spot and contract prices across WMC's product range. Consequently, when BHP's annual profit for 2007 exceeded the WMC acquisition price, it wasn't hard to see why Kloppers suggested himself as the man for the Rio acquisition.

Kloppers' initial deal was to be a cashless affair in which three BHP shares would be offered for every one Rio share. In public, BHP justified the merger by pointing to cost-saving 'synergies' that were allegedly lying in wait in the Pilbara over the next seven years—A$2.8 billion from 'operating and procurement savings' in the third year, with the balance coming from increased volumes by the final year. Even if those figures were taken at face value, they were relatively modest in relation to the size of the new combined enterprise: A$6 billion against a listed value of perhaps A$400 billion wasn't an overpowering achievement. Analysts began to ask questions about unannounced aspects of the synergy.

The potential for market dominance appeared the most likely answer. If the bid had been approved, the standing of 'greater BHP' across a number of global commodity markets would have been without precedent. With 36% of global iron ore supplies, it would have stolen a modest march on Vale, at least for the time being, and bequeathed the two companies more than 70% of the world market in traded iron ore. The new entity would also control over 20% of both coking and thermal coal on a global scale, plus some 12% of copper and 10% of aluminium. However, there was less emphasis on the possibility of bringing about a truly extraordinary situation in the uranium market. The merger would have immediately brought together the two largest Australian mines and the equally huge Rossing mine in Namibia. If BHP's still-evolving plan for the Olympic Dam expansion were added to the mix, it was possible to envisage the potential for a market share in global uranium production approaching 50% just outside the timeframe of the official synergy claims.

The policy focus centred on the Australian Competition and Consumer Commission (ACCC), the watchdog for competitive practices. By definition, the sheer size of the merger meant that there was a public interest in the outcome, and that competition authorities in other places where the companies plied their trade would also want to be heard. Given the high levels of global concentration that threatened across a range of commodities, many analysts initially thought the deal's prospects of getting the nod from so many trustbusters looked slim. The ACCC process dragged on for nearly a full year, only to then signal a seemingly unlikely green light for the merger.

In the event, the ACCC green light counted for more in the long term. When Chinalco eventually entered the fray, its supporters could and did claim that their bid was much less malign than the previously approved BHP–Rio merger. In the short run, however, the ACCC approval was buried when preliminary findings from European competition authorities revealed a hostile attitude and the suggestion of divestment in the Pilbara—a precondition that would have played havoc with BHP's anticipated synergies. In any case, the synergies were beginning to unravel in the face of the more fundamental forces unleashed by the GFC, which saw commodity prices, commodity currencies and the share values of commodity companies all unwind in lockstep in mid-2008.

Chinalco weighs in

If the GFC-led collapse was hard to see during the mid-2008 iron ore price boom, the hostility to the proposed BHP–Rio merger coming out of China was unmistakable. Beijing had already spent considerable diplomatic capital railing about price increases, and the merger played on this already raw nerve. In place of the 'three-pronged grip' of CVRD, Rio and BHP, hints about the malign possibility of an 'iron ore cartel' began to issue from Beijing and other consumer nations.[9] Unlike the capital-constrained Japanese in earlier times, Beijing had buoyant foreign reserves and a variety of mechanisms for placing them offshore, and the way was open for it to put its money where its mouth already was. It did just that in the two Chinalco bids of February 2008 and February 2009.

The first of these plays was strategically defensive, albeit offensive in the tactical sense. In a stunning overnight raid on the London share market, Beijing used the state-owned Aluminium Corporation of China (Chinalco) to acquire 9% of total Rio shares. At A$15.5 billion, this was immediately the largest foreign investment ever undertaken by any Chinese company, and it established Chinalco as Rio's largest shareholder. It was probably not enough to block BHP's proposed takeover, which required 75% shareholder approval to proceed, but it was certainly enough to drive up the acquisition price. BHP soon recognised this by increasing its share swap ratio to 3.4 to 1.

The President of Chinalco, Xiao Yaqing, had phoned Treasury Secretary Ken Henry on the evening of the London raid, proclaiming a desire to be transparent. He voluntarily submitted his bid to the Foreign Investment Review Board (FIRB) for approval, even though it was comfortably under the 15% ceiling that automatically activates an FIRB review. But Xiao also seemed to regard all this as nothing more than a courtesy, publicly observing that activities on the London bourse weren't governed by the decisions of Australia's FIRB. Treasurer Wayne Swan, however, held his own counsel for six months before approving the original purchase—and demanding advance warning of any increased shareholding. During that interval, he also served notice that firms subject to investment by sovereign wealth funds would be regarded as 'strategic' where the corporate governance arrangements of the investor were not clearly separate from their government owner. BHP made good use of this suggestion, and helped ramp up the background level of public anxieties about the activities of sovereign wealth funds in Australia.

By the time the BHP takeover collapsed, Chinalco's defensive gambit was looking very expensive, but Rio's low share price also presented a perfect opportunity for a second bite. Hence, just after the anniversary of its first raid, Chinalco put down a further A$29.7 billion for a wide range of Rio assets and shares: a 14.9% stake in both Hamersley Iron and the massive Escondida copper mine in Chile, 18% of Rio's London listings, plus significant positions in Rio's high-grade bauxite and alumina deposits at Gove and Weipa.

In Australia, the new context of the GFC made these massive sums of incoming Chinese investment look very attractive to a company in the throes of debt refinancing, but also to a federal government that was increasingly concerned with maintaining jobs.

The second bid was more of an alliance than a raid and wasn't entirely unexpected, given Rio's low share price. It nonetheless touched off a much larger volume of political debate in both Britain and Australia. The focus of British concerns was on the alleged low quality of recent decisions by Rio's management, which might by that time have raised roughly similar amounts of capital through a rights offer to existing shareholders other than Chinalco. In Australia, the new context of the GFC made these massive sums of incoming Chinese investment look very attractive to a company in the throes of debt refinancing, but also to a federal government that was increasingly concerned with maintaining jobs. However, even more so than with the first Chinalco bid, the national interest aspects of this corporate alliance quickly spilled into the public realm. Soon almost everyone had an opinion on the matter.

The advice of former Howard Government Treasurer Peter Costello was particularly notable. He highlighted the 'Australianising conditions' he had imposed on BHP in approving its 2001 merger with Billiton, and advised the Rudd Government to follow his lead (Costello 2009). Even a convinced free-trader like *The Australian's* foreign editor Greg Sheridan felt that the government should 'just say no' to the expanded Chinalco alliance.[10] Opinion polls soon suggested that a solid majority was behind this side of the argument.

To improve the chances of success, Chinalco's new chair came to Canberra touting two means of addressing local misgivings: any Chinese directors on Rio's board would absent themselves from discussions where national interests conflicted, and Chinalco would arrange a A$20 billion line of credit to assist the expansion of Rio Tinto's mining operations into China. However, the FIRB was in no mood to be rushed and extended the period for consideration by ninety days.

A new diplomatic game?

This proved to be a critical period. Rio's share price recovered a reasonable amount of lost ground, exposing company managers to an increasingly powerful argument that Chinalco was about to receive valuable company assets on the cheap. Considerable divisions emerged inside Rio's London board, and the new chairman-elect, known to oppose the Chinalco deal, resigned before assuming his post.

His successor was soon in Australia participating in the dialogue of sorts that Chinalco had begun with the FIRB, which was now intensifying against the backdrop of the adverse drift of public opinion. Talk of 'Plan B' had already been let loose by a senior Rio executive, and Chinalco quietly began workshopping significant variations to the proposal that might secure its acceptance. Ultimately, the Chinese appeared willing to concede many things: their influence over marketing, their second seat on Rio's board, and perhaps half of their desired stake in iron ore operations. But Rio's new London team had already informed Chinalco that they were opening discussions along another front—with BHP. The strategic alliance of a few months earlier appeared to be unravelling fast—Chinalco's concessions, if not too little, were coming too late.

The Foreign Investment Review Board

In the late 1960s, the resources boom of that era generated an increase in public concern about 'selling off the farm', and the regulatory framework began to expand reactively across the energy and minerals sectors. In an attempt to get in front of that process, the Whitlam Government legislated the *Foreign Acquisitions and Takeovers Act 1975*, which was followed in 1976 by guidelines for the FIRB from the Fraser Government.

To many supporters of the 1975 Act, the FIRB guidelines of the Coalition government were too moderate. For one thing, the board was housed inside the Treasury, the arm of the federal bureaucracy generally disposed to favour foreign investment. Although only an advisory body, the board was given a mandate that owed a great deal to single tax theory: it was required to assure that the benefits of rising land values brought on by economic growth accrued to Australian nationals. However, the recessionary economic climate after its formation meant that foreign investment proposals were falling away, which knocked some of the harder edges off the more nationalistic attitudes of earlier times. The FIRB wasn't initially overburdened with work.

That began to change in the mid-1980s when, largely as a result of G-7 machinations, the value of the Australian dollar fell spectacularly as the yen soared. The simultaneous liberalisation of Japan's capital account saw its corporations and citizens take an increasing interest in foreign real estate. Although America was their preferred site, yen inflows began to have a considerable effect on the top end of the housing market in Sydney and the Gold Coast, and arguably contributed to a rise in the general level of price inflation. With explicit encouragement from the then Treasurer, Paul Keating, the FIRB began to more actively screen and approve foreign investment in Australian real estate. This became the bread and butter of FIRB business, and today that sector still accounts for 90% of its applications.

More recently, the rise of Big Mining through mergers and acquisitions has become a significant part of the Australian economic scene and a headline-grabber for the FIRB. The Woodside case and its ripples dominated the early years of the century's first decade. Woodside Petroleum was the only Australian member of the consortium behind the development of the North West Shelf gas fields—and the lead player in the sense that it operated the physical infrastructure. Another member of that consortium, the British–Dutch oil giant Royal Dutch Shell, proposed to buy out Woodside in May 2000. Had the bid been successful, Shell would have achieved a controlling position over the consortium and its pace of development. The issue was necessarily referred to the FIRB, which debated it for a long time (some later claimed that the board was divided over the merits of the case). Eventually the matter was referred back to the Treasurer, Peter Costello, for decision. In April 2001, Costello decided not to approve the takeover.

The Foreign Investment Review Board *continued*

Once he proclaimed that the proposal was contrary to the national interest, Costello wasn't required to give any more detailed reasons. For those who were inquisitive about precisely why that reading of the national interest prevailed, there were a wide range of texts. Some were very partisan: Robert O'Neill, formerly the director of the International Institute for Strategic Studies and a Shell board member, saw the rejection as an attempt to neutralise the growing influence of Pauline Hanson's One Nation party. More commonly, analysts thought the main issue was what might be called 'substitution effects' in international markets. Shell had a number of other investments in new oil and gas fields around the region, including some in other Australian provinces, and control of the North West Shelf might have induced it to wind back the pace of development there to crank it up elsewhere.

Whatever the details of the national interest calculus, the Woodside case cast a long shadow over the future of the FIRB. In the following year, when Costello gave a green light to the Mitsui takeover of Mount Isa Mines, the hypothesis about substitution effects seemed vindicated. In late 2004, the big issue was the possible acquisition of WMC by Xstrata, a company with recent bad form in Australia. The previous year, Xstrata had closed down the Windimurra vanadium mine in Western Australia, which had begun operations only three years earlier—in order, it appeared, to drive up the international price of vanadium and concentrate global profits in the hands of its South African operation. Since the previous state government had made significant infrastructure investments around Windimurra, its closure earned Xstrata the eternal opposition of the Gallop Government, which dramatically declared the company 'an enemy of the state' (Pennells 2004). Although this case seemed to raise the same kinds of substitution effects that were thought to lie behind the Woodside case, the FIRB approved Xstrata's bid—although it laid down the precondition that there be transparency in marketing.

Soon afterwards, the rise of Chinese direct investment in Australian resources began to grab the headlines. Most of the interest centred on the role of the Chinese state in providing cheap finance for its investors—a concern that was soon caught up in wider speculation about the growth of sovereign wealth funds. The early 50/50 pairings of Sinosteel with Midwest and Ansteel with Gindalbie also revealed that iron ore, and especially in the new province around Geraldton, was near the forefront of Beijing's interests, although not exclusively so: Sinosteel was also the vehicle for a majority Chinese stake in one of the more promising junior uranium companies, PepinNini Minerals. In dollar terms, however, all these early investments were small beer compared with the Chinalco stake in Rio, although they did ramp up over time. By late 2008, in the context of a Chinese–Japanese struggle for primacy over the new province, Sinosteel's initial Midwest investment of $16 million had grown well beyond $100 million, while its shareholdings stood over 70%. Likewise for Ansteel, which on the one hand spent vigorously to increase its share stakes, while, on the other, arranged a billion-dollar development loan for Gindalbie from the China Development Bank.

Because Rio's abandonment of the second Chinalco bid saved Treasurer Swan from showing his hand, we may never know how he would have played the FIRB card. But in this vacuum, it's reasonable to assume that Chinalco's last-minute rearrangements of the terms on offer reflected its understanding of what Swan would accept. If so, his February 2008 guidelines on sovereign wealth funds—thought moderate at the time—exerted greater influence than most anticipated.

The end came a week before Treasurer Swan was due to deliver his FIRB assessment, saving the Rudd Government from the political agonies that would have inevitably entailed. In place of Chinalco's cash, Rio would now raise A$15 billion from a heavily discounted rights offer to existing shareholders, while BHP would throw in an extra A$5.8 billion for a joint production venture in the Pilbara that would merge all existing projects across the province. This fell well short of the earlier BHP proposal for a full takeover, in that it wouldn't extend to marketing, which each company would continue separately. And the hard-to-pin-down 'synergies' also re-emerged, now considerably pumped up at A$10 billion—a very modest figure, according to informed analysts, but one that retrospectively discredited the 2007 estimate of A$6 billion from a full takeover. This joint venture, it seemed, had some chance of obtaining a green light from the European regulators who had foreshadowed objections (without quite detailing them) the previous October.

Meanwhile, with the public gaze largely fixed on the spectacle of corporate musical chairs, there were substantial developments on the day-to-day commercial front. There was no meeting of minds about new contract prices by the normal April target date, and the Chinese were holding out for large reductions of around 45%. Seemingly at odds with that position, their monthly imports from the Pilbara were consistently surging to record levels throughout the first half of 2009. Industry insiders whose attention had only recently been fixed on Australian infrastructure problems began to report massive queues of fully laden ore carriers off Chinese ports, particularly the iron ore trading centre in Rizhou, Shandong. However, this record demand wasn't matched elsewhere in the region, where the GFC brought cutbacks of ore exports to Japan and South Korea of greater than 60%. Even more paradoxically, China's steel production and exports appeared relatively flat despite Beijing's massive stimulus package. As was evident in many other commodity markets by this time, China's iron ore stockpiles were again building up.

Beijing's purpose remained obscure. In early June 2009, contract price reductions of 33% were agreed with Japanese and South Korean mills, although Chinese negotiators, now led by the China Iron and Steel Association, refused to accept them. Some small mills in north China reportedly struck independent deals in line with Japanese prices, demonstrating once again the lack of unity behind Beijing's industry association.

In the absence of agreement, the benchmark pricing system was therefore being edged towards obsolescence, and BHP's long-favoured option of greater reliance on the spot market, quarterly contracts (or both) was moving nearer to de facto implementation. China's unrelenting high demand had by then pushed spot prices well above the new Japanese benchmark, encouraging the China Iron and Steel Association to fall into line. Potentially transformative territory loomed ahead. This transformation was then confirmed in March 2010 with the collapse of the 40-year old annual iron ore pricing system which has been abandoned in favour of quarterly contracts. The immediate result of these changes was the rapid increase in iron ore prices to around US$160 per tonne, and, perhaps unexpectedly, a demand from the China Iron and Steel Association for an immediate boycott of iron ore imports from the world's three largest producers. If further evidence of the volatility in the iron ore market was needed, this was it.

Recommendations

Notwithstanding the attraction of immediate commercial gains from the quarterly pricing mechanism, it must now be seriously questioned whether greater reliance on short-term sales will serve our national interests in an expanded market that is expected to continue to grow strongly. Price volatility seems the most likely outcome, and this is likely to play havoc with financing for large-scale projects, begetting supply shortages, price rises and speculation over the medium term—not to mention the return to the market of high-cost Chinese supplies. Since around 10% of Australia's export revenue now comes through this single market, no national interest is served by exposing the Australian economy to potentially extreme fluctuations in spot markets.

Given the centrality of the iron ore market to the Australia–China relationship, two complementary measures are available for accommodating national interests on both sides: first, establishing a China–Australia strategic economic dialogue around iron ore issues; and second, edging towards an international commodity agreement.

Institutionalise a bilateral strategic economic dialogue on iron ore

If we leave behind the package of illusions about 'normal commercial relations' in iron ore and 'trade up' our ideas about commodity markets, where might that lead us? As argued earlier, we should take a leaf out of the American book of diplomatic techniques and establish a strategic economic dialogue with Beijing around iron ore. Dialogue over iron ore won't necessarily (let alone instantly) resolve the backlog of issues, but it will help take them out of the hands of tabloid journalists and, to that extent, depoliticise them considerably—a prelude to bringing Canberra's relationship with China back from the brink of current difficulties.

Importantly, Canberra ought not take too much literal inspiration from the range of American prototypes for economic dialogue.

Importantly, Canberra ought not take too much literal inspiration from the range of American prototypes for economic dialogue. Unlike the US, Australia has no interest in pretending it can bring significant military weight to the negotiating table. Therefore, such dialogues ought to be pitched at the ministerial level, with the participation of the major companies and relevant subnational authorities from both sides. In addition, Canberra's aim shouldn't be to correct external imbalances so much as to bring a modicum of structural stability to increasingly important commodity markets—a major error of omission from the 1944 Bretton Woods framework.

Now that iron ore looms large in total Australian exports, this systemic objective has important national pay-offs. It avoids the massive gamble associated with doing nothing; in the first instance, watching a critical market devolve into an interminable series of short-term transactions with volatile prices; and, in the longer run, sitting idly by while Chinese authorities slowly impose their own conception of order on the demand side of the market, beginning with their own domestic arrangements. A dialogue would help lay Chinese fears of an iron ore cartel to rest, while keeping the lion's share of transactions tied to an annualised schedule. When held up against the most likely current trends, a strategic economic dialogue offers the only way to secure these impeccably conservative ends.

Other things could then be added to the dialogue as ballast.[11] Some of them, most notably China's new mining law, have been shunted into the agenda of Australia–China free trade agreement negotiations, where their only conceivable function is to serve as a deal breaker. Others, such as the yawning gap between the standards of domestic and foreign competition in both Australian and Chinese markets, linger on the sidelines without any venue for discussion. These rearrangements ought to be reasonably easy for a Labor Government to contemplate, since China has clearly been identified as the target for a more sustained, effective policy of regional engagement.

Establish an international commodity agreement

The initial impetus towards commodity agreements was rooted in the experience of the Great Depression, when markets for a wide range of primary commodities and resources suffered extreme price declines, sometimes to levels below production costs. This was then followed by the wartime experience of commodity shortages amid thin and uncertain international trade that drove many prices through the roof. The cumulative result was a widely held view that primary commodity markets moved according to an extreme version of boom–bust dynamics.

However, the task of dampening large price fluctuations and reversing any long-term trends to lower prices was not taken up in any systematic manner during the Bretton Woods negotiations. Despite this, UN efforts to form the International Trade Organization ended up with the Havana Charter in 1948, a document that survived the soon-aborted organisation. In particular, the charter allowed for international commodity agreements (ICAs) where they included both producers and consumers in a politically balanced manner.

… there's no reason that the critique of unrestrained markets now emerging out of the GFC should be confined to the realm of finance alone.

Building on this foundation, ICAs went on to enjoy a modest role in trade expansion during the golden age of postwar growth, when periodic agreements between the largest producers and consumers brought structure to the international markets for sugar, tin, wheat and coffee.[12] There was nothing necessarily radical about all this: in three of those four markets, developed countries were the major exporters. Indeed, the balance between importers and exporters inside ICAs suddenly became a great virtue in the aftermath of the 1973 oil shock, when a new and more ominous architecture for commodity marketing was blooded—the producers' association. ICAs then appeared to be a politically acceptable alternative to this more fearsome prospect, and a number of free market economists and conservative strategists from the OECD world rallied to their side.[13]

A decade on, however, the collapse of the International Tin Association saw ICAs pass out of existence altogether, largely because the very idea of bargained outcomes sat uneasily in the company of 1980s doctrines of neoliberalism. However, there's no reason that the critique of unrestrained markets now emerging out of the GFC should be confined to the realm of finance alone. For example, the Rudd Government's attempts to articulate robust principles of energy security ought to open a new door in this old direction.

To date, Canberra's only available response to these concerns has been to play a dead bat and say that commercial forces rule in commodities. A more satisfactory answer to Asian questions about energy and resource security would be to invite mutual exploration of possibilities for an ICA on iron ore. Whether there's the energy or institutional capacity in Canberra for this kind of diplomatic push is a moot point. Raising the bar in this way could constructively address, in a non-discriminatory way, the concerns about energy security that all the rising powers of Asia have been placing before Australian governments in recent times.

Strategic economic dialogues

In 2006, Henry Paulson, President Bush's Treasury Secretary, inaugurated a 'strategic economic dialogue' with Beijing, which the Obama Administration has recently combined with a pre-existing Leaders Dialogue to yield a 'strategic and economic dialogue'. The agenda for these talks largely arises out of US trade deficits with China, which escalated dramatically in the decade or so before the onset of the Global Financial Crisis. Consequently, a range of policy issues that might help redress this bilateral imbalance have been front and centre in these talks: the need for revaluation of the Yuan; the room for greater liberalisation of domestic Chinese markets, and (especially when energy prices are high) Chinese measures to remove demand-side pressure from the oil market.

Behind this array of current issues, this US-initiated dialogue serves to highlight a serious flaw in the design of the postwar multilateral payments system. While economies that run structural deficits usually end up in the hands of the IMF, there has never been a matching mechanism to force economies with structural surpluses to revalue their currencies. The absence of such a mechanism has, in turn, been one of the major causes of global economic imbalances—the very imbalances that almost everyone now detects in the making of the Global Financial Crisis. Similarly, a Chinese–Australian strategic economic dialogue over iron ore would draw attention to the fact that the disciplines of the GATT and WTO have never applied to international trade in raw materials. It would be unlikely to 'civilise' this boom and bust market, but it would at least draw attention to what needs to be done along the multilateral front.

Chapter 3

INDIA AND URANIUM

For three decades, it has been an article of faith in Australian diplomacy that uranium is a strategic commodity so intrinsically important to the goal of nuclear nonproliferation that a bilateral safeguards agreement needs to be a condition of supply. In recent times, however, there has been evidence to suggest that uranium is being regarded as a strategic commodity for reasons other than its role in the nuclear fuel cycle.

Some of the evidence comes from the supply side, such as the recent repeal of the Australian Labor Party's 'three mines' policy and the desire to open up Australia's vast reserves of uranium ore. Other evidence comes from the demand side, where Australia's bilateral safeguards agreements are having less to do with improving standards of international behaviour in the nuclear fuel cycle, and more to do with the energy security concerns of key strategic partners.

This chapter focuses on the dilemmas for Australian policy arising out of the Bush–Singh deal of July 2005—a deal that has seen India sidestep the Nuclear Non-proliferation Treaty (NPT) and obtain important recognition for its status as a de facto nuclear weapon state. The US–India deal has also undercut the universality of the Nuclear Suppliers Group policy of demanding full-scope safeguards as a condition of supply.

Although the Rudd Government is maintaining the traditional Australian defence of the nonproliferation and safeguards regimes, this creates a major obstacle to its efforts to improve the general standing of bilateral relations with a country of emerging strategic importance in Asia. Three possible exits from this dilemma will be surveyed.

Uranium and clout

It helps to contextualise these contemporary developments by recalling that India has always been a problem for the NPT system, at least since its 'peaceful' nuclear test of 1974.

The provocative label the Indian Government gave to the test mocked both the peaceful end-use obligations that Canadian governments had required of New Delhi when supplying a research reactor in the late 1950s, and also the provisions for peaceful nuclear tests that had been written into the NPT a decade later.

India's 1974 test was one of the main reasons why Washington soon moved down the path to banning the reprocessing of nuclear fuel, the chemical process that extracts plutonium from spent nuclear fuel rods. So when a new US Nuclear Non-Proliferation Act was finally agreed in 1978, it attempted to prevent the spread of those advanced technologies integral to 'the plutonium economy' by encouraging a rather simpler nuclear fuel cycle known as the 'once-through' fuel cycle.

One of the implications of this new American technological choice was particularly important in Australia, where public debate was beginning to emerge from the period of intense investigation of the nuclear fuel cycle centred on the Ranger Inquiry. If a ban on reprocessing nuclear fuel could be made to stick, global growth of the nuclear industry would require a vastly expanded uranium mining industry to provide for its needs.

The discovery of high-grade uranium at Kakadu in the early 1970s, followed soon after by the immense but low-grade Olympic Dam deposit, dovetailed neatly into this American 'technical fix' of the problem of proliferation. Bringing those deposits to market would help alleviate any concerns about fuel security that might otherwise arise out of Washington's new policy.

Ordinary Australians were largely unaware of this American connection, although they'd rather hesitantly given a conditional green light to the resumption of uranium exports, subject to the rollout of an Australian system of bilateral safeguards agreements. In elite political and bureaucratic circles, however, this alliance dimension of Australia's uranium debate was better understood and warmly welcomed, for it promised to deliver a uranium market heavily skewed in favour of sellers throughout the indefinite future.

In terms of resources diplomacy, Australia might be able to simultaneously enjoy both high prices and high export volumes for its uranium exports, and avoid what would normally be a choice between them.

In terms of resources diplomacy, Australia might be able to simultaneously enjoy both high prices and high export volumes for its uranium exports, and avoid what would normally be a choice between them. That assumption was obvious in some of the public calculations that the Fraser Government made about future returns from this new export industry as it was beginning to come on line. It also seemed entirely possible that all of these economic rewards could go hand in hand with consumer acceptance of Australia's bilateral safeguards, which would constrain the purposes to which Australian-obligated uranium could be put.

Following earlier experiences with the uranium cartel, this episode is best regarded as the beginning of a second phase of attempted Australian resources diplomacy in uranium. While the original plans were exceedingly ambitious, the unfolding reality revealed inescapable trade-offs between economic and strategic objectives, and between prices and volumes.

From the very beginning, consumer acceptance of Australia's proposed safeguards had been less welcoming than hoped, and most especially in Europe. Significant dilutions of the Fraser Government's Model Safeguards Agreement were made in order to secure early sales; prices beat a nearly constant retreat from the peaks achieved under the cartel; and export volumes failed to reach the levels predicted for the new generation of Australian uranium mines.

Olympic Dam, the most recent addition to this cohort, fell well short of the output its owners had predicted for it in its indenture agreement. Energy Resources of Australia Ltd, the owner of the high-grade Ranger mine, fulfilled its supply obligations at one point by buying uranium in the global spot market rather than by working its Australian deposit. Australian safeguards might have set the high-water mark for standards in the uranium market, but the slack market meant there was no compulsion for others to engage in a 'race to the top'. These became the visible symptoms of the design failure of this second phase, which nonetheless lived on in the absence of a formal burial.

While the big picture of the once-through fuel cycle wasn't realised, the inspiration of Australian nuclear activism allowed many smaller pictures to be drawn in Canberra. One of the most important was the Australian diplomatic push for full-scope safeguards—safeguards over the whole of the civil nuclear sector—as a precondition of supply of nuclear materials. Australian governments were early and persistent advocates of this policy, and were duly rewarded when the Nuclear Suppliers Group adopted it soon after the end of the Cold War.

One consequence was a hardening of the preconditions for civil nuclear trade with India, which by remaining outside the NPT system became one of the main subjects of the new Nuclear Suppliers Group policy. So when the Bush Administration began responding to a growing convergence of trade and security interests with India in 2005, this significant Australian diplomatic success from earlier times loomed as a likely casualty.

Deal of the century

A Washington – New Delhi alignment has always offered some natural synergies as a marriage between the world's most powerful and most populous democracies. But it only began to assume an important strategic dimension after then US President George Bush and Indian Prime Minister Manmohan Singh issued a joint statement on 18 July 2005. Among other things, the statement covered cooperation on nonproliferation and security matters, and explicit American assistance to help India to become a major world power in the 21st century.[14]

At the time, President Bush said that he'd work to achieve full civilian nuclear cooperation with India as it realised its goals of promoting nuclear power and achieving energy security.[15] More recently, the Obama Administration has acknowledged the central role that India will play in reformulating US grand strategy.[16] For Australian governments, which still work within the remnants of a nuclear policy framework laid down thirty years ago, civil nuclear cooperation poses a complex challenge.

As part of the deal, the Bush Administration agreed to facilitate civilian nuclear technology transfers and create the conditions for India to purchase nuclear fuel in the international marketplace. Washington has accommodated India's current position as a nuclear power that hasn't signed the NPT by amending existing US legislation and modifying the nuclear nonproliferation regime through a policy of 'exceptionalism'.

> The US–India civilian nuclear agreement is indicative of the expanding relationship between the two states.

The US–India civilian nuclear agreement is indicative of the expanding relationship between the two states. Significantly, the Agreement for Cooperation Between the Government of the United States of America and the Government of India Concerning Peaceful Uses of Nuclear Energy (the 123 Agreement) states that both parties want to strengthen the strategic partnership between them.[17] However, the proposed deal was incompatible with US domestic law on the sale of nuclear material to non-NPT states. To sidestep the resulting legal hurdles, the Henry J Hyde United States – India Peaceful Atomic Energy Cooperation Act of 2006 (the Hyde Act) modified the requirements of section 123 of the US Atomic Energy Act of 1954 to permit nuclear cooperation with India.

The 123 Agreement

The 123 Agreement:

- confirms the desire of both countries to engage in full civil nuclear cooperation, including research and development, nuclear safety, and commercial trade in nuclear reactors, technology and fuel
- affirms the fuel supply assurances made to India by President Bush on 2 March 2006, including creating the necessary conditions to allow India access to the international fuel market, and by supporting the creation of an Indian strategic fuel reserve
- grants consent to India for nuclear fuel cycle activities (in particular, allows reprocessing in India by establishing a new facility under International Atomic Energy Agency safeguards dedicated to reprocessing safeguarded nuclear material, and both countries agreeing on arrangements and procedures under which reprocessing will take place)
- commits India to appropriate safeguards on all civil nuclear material and equipment subject to the agreement that it will be used only for peaceful purposes, including through a reaffirmation of India's commitments to safeguards in perpetuity
- reinforces the commitment of both countries to nonproliferation efforts
- preserves the rights of both countries to terminate cooperation and request the return of transferred items under certain circumstances
- creates the legal basis for the US to be a stable, reliable and predictable supplier for India's civil nuclear energy market.

Given international sensitivities about the integrity of the nonproliferation regime, the 123 Agreement also contains a number of important restrictions and caveats. For its part, India is required to separate its civilian and military nuclear sectors and to open fourteen of its twenty-two nuclear reactors to inspections by the International Atomic Energy Agency (IAEA). Somewhat more contentious for the Indian nuclear establishment were demands from the US Congress that India refrain from any further proliferation in the form of producing fissile material or testing nuclear weapons.

The deal hasn't been without other controversies. Prominent Indian nuclear scientists publicly objected to the Hyde Act as the basis for the 123 Agreement on the grounds that full cooperation in civilian nuclear energy would still be denied to India, especially in areas of reprocessing and enrichment related to the nuclear fuel cycle.

The 123 Agreement also had to satisfy the requirements of the 45-member Nuclear Suppliers Group (NSG) if restrictions on exports of nuclear material to states that are nonsignatories of the NPT were to be removed. The US proposal to grant a waiver to India of the full-scope safeguards of the group's export guidelines achieved a consensus approval in the NSG on 6 September 2008.

India-specific safeguards had already been concluded by the IAEA on 1 August 2008. Having jumped through the various legal and political hoops, the 123 Agreement was approved by the US Congress and signed into law by President Bush in October 2008 as the United States – India Nuclear Cooperation Approval and Non-proliferation Enhancement Act.

The deal on US–India civilian nuclear cooperation is only one dimension of a much deeper shift in strategic thinking by both states. Washington is also intent on pursuing the relationship in the military–strategic area through regular joint naval exercising and proposed sales to New Delhi of sophisticated military equipment. For example, Washington has allowed Boeing to contest an Indian tender for 126 multirole combat aircraft by offering its F/A-18 E/F Super Hornet fighter–bomber, which is currently in service with the US Navy. The same plane forms the basis of Australia's bridging air combat capability.

Some analysts suggest that India is simply normalising its relationship with the US after a long period of misunderstanding and mistrust.[18] The end of the Cold War and the end of India's strategically ambiguous position as an ideological go-between provided the conditions for a closer India–US bilateral relationship. The Clinton Administration first reassessed its engagement with India after the furore that accompanied India's May 1998 nuclear tests. Following Clinton's visit to New Delhi in 2000, the US embarked on a new engagement strategy, which intensified over the two terms of the Bush presidency and has continued under Obama.

India has common interests with the US in fighting violent extremism and in a normative attachment to democracy. These are pivotal elements for the Obama Administration. The US has consistently emphasised the importance of India as the world's largest democracy, and the role of shared values in transforming the relationship. The recent terrorist attacks in Mumbai have only produced greater empathy in Washington with India's concerns about jihadist-inspired terrorism emanating from Pakistan.

However, a major driver of the India–US strategic realignment is the concern of the US (and its key East Asian ally, Japan) about the strategic challenges posed by China's growing economic and military strength. Although it hasn't formally articulated a policy of containment, these power fluctuations are compelling the US to seek out likeminded powers to resolve global and regional challenges. India may in time become a strategic partner of the US, but it won't be an ally in the same sense as Australia or Japan. Nonetheless, the US and India are clearly engaged in a joint hedging strategy to balance a potentially different China in the future.

Implications for Australia

The 123 Agreement caught Australia by surprise. At a joint press conference in New Delhi with Manmohan Singh on 6 March 2006, then Prime Minister John Howard stated that his government was anxious to obtain more information about the civil nuclear cooperation process. He also referred to the Australian Government's default position whenever this question is raised—Australia only exports uranium to countries that are members of the NPT.

Nevertheless, Howard agreed that the 123 Agreement was a significant and positive development between India and the US. It was particularly important because it brought India's civil nuclear industry within the ambit of the international safeguards inspection regime. Howard indicated that his government would seek advice on whether Australia should support the 123 Agreement within the NSG.[19]

The then Minister for Foreign Affairs, Alexander Downer, revealed in July 2007, when negotiations on a bilateral nuclear cooperation agreement between India and the US were being concluded, that Cabinet would discuss a submission for the potential sale of Australian uranium to India.[20] On 16 August, after the text of the 123 Agreement was revealed, Howard announced a significant change to Australia's uranium export policy, allowing for an in-principle agreement to supply Australian uranium to India, subject to a number of conditions, including guarantees that the uranium would be used only for power generation (DFAT 2007).

Howard said that countries need to find better ways to bring India within the nuclear nonproliferation regime:

> It has indicated that it does not intend to join the nuclear non-proliferation treaty so we think it worthwhile finding practical ways to bring it into the non-proliferation mainstream [through the 123 Agreement].[21]

The comment reflected the judgment, prevalent among senior Bush Administration officials at the time, that formal arms control treaties were outdated and impractical. It also reflected an assessment that, although India remained outside the legal reach of the 30-year-old nuclear arms control regime, it had certainly been a more responsible nonproliferation actor than either of its immediate neighbours to the west and north-east. The concept of a nonproliferation 'mainstream' remains untested in international legal circles, but it captures something of the evolution of thinking on nuclear arms control that has occurred over the past decade.

Australia's growing trade and security relationship with India was another factor that influenced the decision to allow the supply of uranium. Australia is a major supplier of raw materials to the Indian economy, and currently the eighth-largest source of its foreign imports. India's increasing dependency on energy imports to meet industrial and consumer demands means that Australia remains well placed to be a preferred supplier of raw materials to fuel the Indian economy.

As ever, the politics of the decision were never far from the surface. The federal opposition leader at the time, Kevin Rudd, stated that a Labor government would scrap any agreement to sell uranium to India, providing a much-needed point of policy difference with the Howard Government in the context of a federal election campaign:

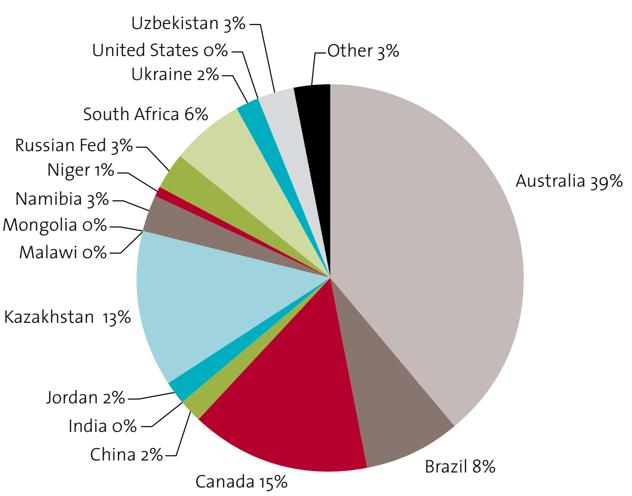
> No one in Australia wants a nuclear arms race aided by us in the Indian sub-continent or between India and China because we've failed to properly ensure the upholding of the NPT and the IAEA safeguards regime under it.[22]

Since taking office on 3 December 2007, the Rudd Government has maintained the ban on uranium sales to India but has pursued closer economic and strategic ties as vigorously, if not more so, than previous Australian governments. At an address to the Indian Council of World Affairs in New Delhi, the Foreign Minister, Stephen Smith, said that the Australian Government is committed to taking the relationship with India to a new level, 'to the frontline of Australia's international relationships'. He stated that Australia's future was linked to its partner states in the Asia–Pacific region.[23]

The Australian Government faces a policy conundrum in its efforts to expand its engagement with India. India looks to Australia, among other states, to supply its growing need for energy resources to increase electricity production, including coal, liquefied natural gas and, significantly, uranium, which is viewed by many Indians as the most important issue between the two countries. Recently, that pressure has begun to increase with the Indian Commerce and Industry Minister, Anand Sharma, urging the Rudd Government to seize the historic opportunity that would come from the supply of Australian uranium to India.[24] Both sides are conscious of the fact that Australia has by far the largest share of estimated uranium deposits—39% of the world's reasonably assured resources (Deloitte 2008).

Despite the current uranium ban, Australia took a constructive approach at the IAEA Board of Governors meeting and in NSG discussions over an India-specific exemption. Australia's support for the waiver took into account India's positive record on nonproliferation, the nonproliferation benefits of bringing its civil nuclear industry under the safeguards regime of the IAEA, India's status as a rising power, and the strategic importance of the 123 Agreement for both India and the US.[25] Of course, these are the same reasons that the former Howard Government used to argue the case for the sale of Australian uranium.

Figure 4: Reasonably assured uranium resources, January 2007 (tonnes U)



Source: Australian Uranium Association, www.au.org.au/content/resources.aspx. Accessed 7 April 2010.

Exit strategies

The supply of uranium sits at the intersection of all the major issues confronting the West's strategic engagement with India—globalisation, nuclear proliferation, energy security and climate change. For Australia, the problem is particularly acute. We're caught between the strategic imperatives of engaging more closely with an emerging Asian great power, and maintaining our support for a rules-based international order.

From a strategic trade policy perspective, there are strong incentives for Australia both to liberalise global markets in key commodities, such as uranium, and to contribute to the reduction of greenhouse gases through the promotion of clean energy, including nuclear power generation. Such incentives will only increase as the demand for energy security in Asia grows.

The solution to this particular conundrum hinges on the government's long-term assessment of the nuclear nonproliferation regime. The NPT has been a remarkably effective and resilient instrument since it was signed in 1968. It has dampened global proliferation pressures and provided important normative constraints on states at crucial moments during the Cold War. With only four countries outside the NPT, it's now one of the most universally recognised pieces of international law.

But the NPT regime can no longer bear the weight of the global nonproliferation norm by itself. Most states now recognise, and Australia has strongly supported, more direct intervention measures through counter-proliferation initiatives such as the US-led Proliferation Security Initiative.

… the NPT regime can no longer bear the weight of the global nonproliferation norm by itself.

The argument that selling uranium to India would break the back of the NPT regime isn't supported by the available evidence. Indeed, the international safeguards arrangements and safety issues would be better addressed through closer bilateral cooperation with India on the nuclear fuel cycle (Gordon 2008). The emerging consensus among strategic analysts is that, on balance, the long-term strategic, economic and environmental benefits of such a deal outweigh any lingering concerns about the integrity of the nonproliferation norm.

The US–India deal was never likely to be a fatal blow to the NPT, but it was a blow nonetheless—and a considerable one to bipartisan Australian nonproliferation policy, which for a decade struggled to get 'full-scope' safeguards universally accepted as a condition of supply for nuclear materials. The full-scope principle has now been compromised and, although India is said to be an exception, one exception tends to beget another over time. In any case, without having signed the NPT, India is now being treated more or less as if it were one of the NPT's recognised nuclear weapon states.

However, there is a diplomatic opportunity to use these events to strengthen the nuclear nonproliferation and disarmament regime, rather than weaken it. Three possibilities require consideration. The first builds on the exception of Taiwan, a country that receives Australian uranium without having a bilateral safeguards agreement. The second takes its cue from the bilateral US–India deal. The third involves blending the multilateral legal regimes on nonproliferation and nuclear testing.

Option 1: The Taiwan exception

Australia already sells uranium to a non-NPT signatory—Taiwan. Taipei ratified the NPT in 1970, although the effect of the ratification was nullified at the end of the decade when China's seat in the UN was transferred to the mainland. During that transition period, and in large part because of it, Taiwanese governments appeared to swing some of their nuclear research behind military applications, causing serious problems in Washington, which had previously supplied nuclear technology on the understanding that it would only be used for civil purposes. Washington therefore sought assurance about the continuity of those peaceful purposes by conducting its own inspections of Taipei's facilities to verify the nondiversion of nuclear materials. Later, American inspections were given legitimacy by the IAEA.

As all these arrangements were falling into place, Taiwan also sought to diversify its sources of uranium away from South Africa, with Canada and Australia as first choices. In 1986, leaked documents suggested that the owners of Roxby Downs might be about to 'launder' supplies to Taiwan through sales to France, which at that time was also not an NPT member.[26] In the event, Canada won this two-horse race in 1993 with a proposal that featured the enrichment of Taiwan's uranium in the US—which meant that it obtained cover from the American inspection effort.

Australia was now open to following that precedent, which is what the Howard Government eventually did. In 2002, a memorandum of understanding that essentially copied Canadian policy was signed with Washington. In 2006, the icing was put on the cake immediately after Australian safeguards with Beijing were signed, when it was revealed that the two Australian uranium exporters already had 'ready to go' commercial contracts with Taipei.

It's arguable that, in the aftermath of Howard's China–Taiwan double play, his government might have been about to put a similar mechanism in place to supply Australian uranium to India. In March 2006, Howard took senior representatives of Australian mining companies with him on his visit to New Delhi, which was putting serious pressure on Washington over assured fuel supply—something that Howard could deliver in spades.[27] But Howard couldn't act until the 123 Agreement and IAEA safeguards were in place, and Indian domestic politics kept both on hold through his time in office.

In theory, now that both deals are done, the way is open for the Rudd Government to finish the job. However, as for Bob Hawke and Gareth Evans in the 1980s and 1990s, the main inhibitions are in the realm of public appearances: Taiwan-like arrangements look too slick and too tacky at the same time. At least until the 2010 NPT review conference is over, political prudence dictates that the Taiwan exception ought not be regarded as a precedent.

Option 2: Hyde and seek

Like the US, Australia has vested interests in ensuring that international safeguards on nuclear material are as comprehensive and transparent as possible. The conditions, restrictions and obligations in place as part of the 2006 Bush–Singh deal provide a useful benchmark against which Australia could consider the negotiation of a separate bilateral agreement with India.

Such an agreement would require the amendment of the Australian *Nuclear Non-Proliferation (Safeguards) Act 1987*. The US Hyde Act shows the general contours of the type of amendments that would be necessary, including a waiver on exports of uranium to non-NPT members, coupled with specific provisions on the steps India would need to take to ensure that Australian uranium isn't diverted to the nuclear weapons program. This might open the door to a simple step: that a signature on the NPT or the 1996 Comprehensive Nuclear Test Ban Treaty (CTBT) should be the precondition for the supply of Australian uranium.

A formal legislative mechanism such as the Hyde Act has some other obvious advantages. Assuming it had bipartisan support in the parliament, it would be a relatively quick, transparent and self-contained approach.

Option 3: Blended multilateralism

One of the historic flaws of the NPT is that it draws the distinction between nuclear and non-nuclear weapon states using a simple timeline: a nuclear weapon state is one that tested a nuclear device before 1967. Looking ahead, one of the obstacles along the road to nuclear disarmament is that India's signature is required on the CTBT for that treaty to come into force. Without an operating CTBT, there's no such thing as a road to nuclear disarmament.

The historic weakness and the looming obstacle are capable of simultaneous and mutually supportive resolution. If the NPT were amended so that a nuclear weapon state is redefined as one whose nuclear status had been verified by the CTBT, and if the entry-into-force provisions of the CTBT were pared back so that only the signatures of states that have tested nuclear weapons are needed to bring the system into operation, there would be much greater all-round enthusiasm for moving the current nonproliferation and disarmament system forward.

Canberra's uranium supply policy could play an extremely useful supporting role in aligning India behind such a package deal of multilateral modifications. At the moment, a signature on the 1968 version of the NPT is one of the preconditions of supply written down in Australia's bilateral safeguards policy. For India, that's a complete impossibility without its own nuclear disarmament, since the NPT's timeline means that there's no provision for states to enter the treaty once they have tested. Traditionally, it's been argued that any shift away from this timeline would 'reward' late testers by allowing them to 'blast their way' into the nuclear club. Whatever the past virtues or vices of that argument, that's precisely what India has now been able to achieve through the Bush–Singh agreement, so the traditional objection to NPT amendment can be dispensed with.

The same is true of Australian nuclear supply policy. It could be reworked so that signatures on the amended NPT and CTBT become a precondition for supply—thereby giving New Delhi a considerable incentive to think seriously about the virtues of multilateralising its private American agreement.

These three options aren't mutually exclusive, and some of them could be pursued in combination, but the current policy of a bet each way is unsustainable in the longer term. India's nuclear isolation is inconsistent with its emerging geopolitical role and the tide of international opinion on energy security. There are sound economic, strategic and environmental reasons for Australia to work closely with India on energy security. Uranium is the key to that goal.

Chapter 4

REDUCING THE RISKS

Throughout 2009, as the system for setting iron ore prices edged towards the brink of its own transformation, a broader crisis progressively engulfed Canberra's relationship with Beijing.

Seen from the Chinese capital, the components were many and varied: Rudd's lecture in Mandarin to Beijing University students about human rights and Tibet; the naming of China in Canberra's Defence White Paper of April 2009 as a potential military threat in the distant future; Rio Tinto's rejection of the enhanced Chinalco offer; the visit to Australia of Uighur activist Rebiya Kadeer, and the screening of a documentary about her life at a Melbourne film festival.

From the Rudd Government's vantage point, the one overwhelmingly significant issue was the arrest in Shanghai of Rio Tinto's price negotiating team for China on the allegation of spying and obtaining state secrets through bribery. Although the allegations resulted in more modest formal charges (and the eventual conviction) of one Australian national, Stern Hu, Rio Tinto's operations in China stood in considerable disarray.

Four months later, at the end of the East Asia Summit, when some of the immediate heat coming out of these mid-year issues had dissipated, Foreign Minister Stephen Smith announced that it was 'business as usual' for the bilateral Australia–China relationship.[28] His choice of phrase was anodyne diplomatic boilerplate at one level and unusually interesting at another—because the one thing that so obviously had not been restored was the structure of the iron ore market. Given the dramatic shift in pricing negotiations in early 2010, and further hints towards consolidation of iron ore supply through the possible merger of Rio Tinto and BHP Billiton, the structure of the bilateral iron ore market between Australia and China appears increasingly in need of repair. Sustained and serious thought needs to be given right now to the future structure of the market that's the very core of Australia's export interest in China.

To the west in New Delhi, the same need arises in a completely different structural context. India is now Australia's fourth-largest trading partner, having overtaken the US during 2009. But the one commodity that the Indian Government would really like to source from Australian suppliers—uranium—is denied it by a time-honoured Australian strategic policy intended to support the NPT. For this commodity, there's been no business at all, but the strategically animated Australian policy that sustains this exception is itself obsolete and in need of rethinking. India–uranium and China–iron ore therefore have a yin–yang relationship with each other, where the one commonality is the highly questionable character of Canberra's construction of the commercial–strategic interface.

Michael Wesley has appropriately argued in relation to China that Canberra's greatest foreign policy challenge through the coming decades will consist of 'managing the dissonance' coming out of Beijing's strategic and economic rise.[29] Notwithstanding success in other domains, the Rudd Government is currently failing this test of strategic–economic integration. And it's failing the same test in other ways in its (non-)dealings with New Delhi. So, what can be done under the name of national economic security policy when the usual diplomatic constructs produce failure?

The current dialogue between Canberra and Beijing over iron ore has gradually become infused with a new adjective: 'strategic'.

The current dialogue between Canberra and Beijing over iron ore has gradually become infused with a new adjective: 'strategic'. The drift in this direction began when the Howard Government conferred market economy status upon Beijing to kick-start negotiations over a bilateral free trade agreement—an end point that was immediately described by Chinese authorities as a 'strategic partnership'. Then, when Chinese investment in Australian minerals was beginning to boom in 2007, Beijing simultaneously brought down new domestic regulations that ruled out foreign investment in large swathes of its own minerals sector, allegedly on the grounds of the sector's 'strategic value'.

Canberra responded in part by placing China's new minerals policy on the agenda of bilateral free trade agreement talks. The following year, the upgrading of Australia's foreign investment guidelines in the wake of the initial Chinalco bid made it clear that Canberra would henceforth regard inward investment in Australia by sovereign wealth funds as 'strategic'.

Consequently, the proposition that the iron ore market moves according to commercial rather than governmental preferences is no longer tenable. Indeed, the analysis in this report suggests that it was never true. The leading customers for Australian iron ore have always regarded their purchases as serving national strategic goals. And when the main customer in a market follows a logic of strategic calculations, the failure of the main supplier to accept the customer's definition of the game sets the supplier up to receive 'the sucker's payoff': oversupply, followed by falling prices. Sheer size, usually the great goal of Australian policy, is normally a self-defeating asset for a commodity supplier unless accompanied by self-restraint.

Australians have customarily accepted that the one standing exception to this rule of commercial primacy is uranium, where the market's strategic character arises directly out of the nature of the commodity itself and its self-evident potential for military use.

Australians have customarily accepted that the one standing exception to this rule of commercial primacy is uranium, where the market's strategic character arises directly out of the nature of the commodity itself and its self-evident potential for military use. However, the uranium industry is no longer unique. A case can be made that all major industrial raw materials are now strategic, especially for the nations that produce most of them. What's happened in the uranium trade has lessons for the trade in other commodities, particularly other minerals.

In conjunction with the Olympic Dam expansion, the abolition of the 'three mines' policy by the federal Labor Party (and state branches' slow acceptance of the repeal) threatens to unleash the Australian supply of yellowcake into the global market over the medium term. Because the overall future of the so-called 'nuclear renaissance' now rests in large part on recessionary forces, there's great potential for fuel supply to once again exceed future demand by a considerable margin. If that happens, uranium prices will resume the slow decline they followed for the first two and a half decades after Australia entered the market. Strategic influence will not arise directly out of market share, but from meaningful adjustments to the ends served by uranium sales.

The risks in iron ore are multidimensional. While prices are presently going up, revenue declines must also be expected over the medium term for at least one of two reasons: the first, the rise of the Australian dollar; the second, exacerbation of the longstanding problem of overcapacity in iron and steel production caused by the heady investment targets in Beijing's stimulus package. Meanwhile Australia's reliance on the China market for iron ore exports has soared to around 70%, a rise of some 20% during 2009. Some of this is substituting for expensive domestic iron ore production in China, but large and low-cost additions to China's domestic reserves have also been announced and will, no doubt, be developed over the longer term.[30] Clearly, a substantial share of high Chinese imports is already going into stockpiles, which could be drawn down at any time for economic or strategic reasons.

Under any of these scenarios, there would be significant backwash effects over the external balance of the Australian economy. With China now standing as the sole contributor of any significance to global growth, the preconditions for a collapse of the Australian external balance are in place once again. The 2009 Australian federal budget anticipated a decline in the terms of trade by 13%, and figures nearly twice as large can be found in the projections of some government agencies. If those declines continue for a string of years, there's the potential to revisit Paul Keating's part-experienced, part-imagined 'banana republic' crisis of 1986.[31]

Reducing those risks will be no easy task for the Rudd Government. To start with, the task calls for a frank acknowledgment of the strategic nature of the problems. Canberra needs to leave behind the already outmoded view that commodity markets move in response to normal commercial forces. We desperately need to 'trade up' our conceptions of how these markets work and how they do not. If we don't, we'll increasingly expose the Australian economy to potentially vicious boom and bust movements of speculative forces—an unacceptably high risk in volatile times when resource exports loom larger than ever in the balance of national trade.

The time has come for the Australian Government to jettison much of the ideological and policy baggage that was associated with the growth phase of the minerals export sector.

The time has come for the Australian Government to jettison much of the ideological and policy baggage that was associated with the growth phase of the minerals export sector. What Alexander Downer called 'small country assumptions' are not appropriate for a country that quite rightly aspires to leading status in these commodities, and slavish adherence to them is likely to be self-damaging. But so, too, are the simplest kinds of 'big country assumptions', where size alone is assumed to bring leverage.

Although the policy recommendations outlined in this paper are undoubtedly challenging, their risks and costs must be set against those of doing nothing. Economic and strategic risks to our national interests are building up inside the two markets analysed, and ideas about how to manage and mitigate them need thoroughgoing public consideration.

Endnotes

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3 For the definitive study of this important example, see Adler-Karlsson (1968).

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12 For a review of the achievements of ICAs done near the end of the long boom, see Radetzki (1970).

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24 See 'PM urged to sell uranium to India', *Australian Financial Review*, 6 April 2010, p. 1.

25 Doorstop interview with Stephen Smith MP, Taj Connamera Hotel, Chennai, India, 9 September 2008, http://www.foreignminister.gov.au/transcripts/2008/080909_doorstop.html.

26 See 'Taiwan linked to sale of Roxby uranium', *Canberra Times*, 25 October 1986.

27 For an analysis written at that time about how this might pan out, see Leaver (2007).

28 'Aust–China relations on the improve—Smith', *AAP Financial News Wire*, 25 October 2009.

29 See Wesley (2007).

30 This announcement was, perhaps, a reminder to Rio of what it was now missing out on. Had the second Chinalco deal gone ahead, Rio would have had preferential access to mining in China, along with a substantial line of credit supplied by Beijing.

31 For an authoritative analysis that leans in this direction, see Shann (2009).

Acronyms and abbreviations

ACCC	Australian Competition and Consumer Commission
CTBT	Comprehensive Nuclear Test Ban Treaty
CVRD	Companhia Vale do Rio Doce
FIRB	Foreign Investment Review Board
GFC	global financial crisis
IAEA	International Atomic Energy Agency
ICA	international commodity agreement
NPT	Nuclear Non-Proliferation Treaty
NSG	Nuclear Suppliers Group

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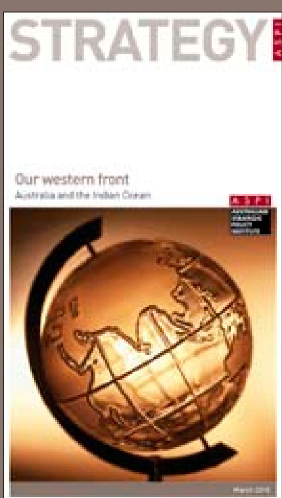

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