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Trade, investment and Australia's national security

...or how I learned to stop worrying and love Chinese money

Mark Thomson

Despite the travails of a two-speed economy, these are relatively good times for Australia. While the rest of the developed world grapples with crippling debts and the most pervasive economic malaise since the Great Depression, Australia enjoys the warm glow of low public debt, close to 5% unemployment and the prospect of 'on trend' economic growth.

Many factors have helped shelter Australia from the economic tempest, but it's been our integration into the international economy that's been critical. Two things stand out. First, our economy continues to be buoyed by the burgeoning global demand for resources, in particular from China. Second, thanks to decades of foreign investment, our economy is substantially larger and more productive than it otherwise would have been.

LNG (liquefied natural gas) tanker at the Karratha gas plant loading terminal, Western Australia © Woodside Energy Ltd.

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Yet misgivings emerge from time to time about our dependence on both exporting and foreign investment. In the case of exports, it's been suggested that our growing trade with China is somehow incompatible with our military alliance with the United States. The dilemma is usually posed as follows: can we simultaneously grow our economic interests with China while preserving our strategic interests with the United States?

In the case of foreign investment, there are many concerns, from questions about food security to the risk of espionage by foreign firms. Of late, particular concerns about sovereign wealth funds and other state-controlled enterprises have emerged.

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This paper examines the impact of trade and inwards foreign investment on Australia's national interests and security. It begins with a primer on the economics of global trade and investment. That's followed by a summary of Australia's economic engagement with the rest of the world, covering two-way trade and foreign investment. The subsequent two sections examine the strategic consequences of current and emerging patterns of Australian trade and inwards foreign investment, respectively. Two further sections explore the diplomatic and indirect impact of our trade and investment. Conclusions are set out in the final section.

Globalisation, prosperity and the national accounts

The world is not homogeneous. There are significant variations between countries in climate, geology and population, and there are often profound differences in the depth and scope of economic development. What one country has in abundance, another will lack; what one can produce easily, another will only achieve with great effort. These differences lead to what economists call 'comparative advantages'.

It's a simple exercise in arithmetic to show that such differences open up the possibility of greater overall efficiency. If countries concentrate on the things they do relatively more efficiently, and the resulting products are then traded among nations, more can be produced and more can be consumed than would otherwise be the case. This conclusion holds with surprising generality, not just when two countries possess absolute advantages in complementary areas. It turns out to be sufficient for there to merely be different relative efficiencies of production of various goods *within* each of the countries. That means that trade can benefit almost any country, including one that is in every respect more (or less) productive in absolute terms than its prospective trading partners. It's this remarkably wide ability to generate benefits that's at the heart of the argument for free trade.

But there's a complication. At least initially, opening an economy to foreign trade creates winners and losers. The subsequent adjustments can be painful for individuals and politically difficult for governments. Nonetheless, trade has expanded steadily over the past six decades and contributed to a surge in living standards globally. It's not just that consumers almost everywhere can now afford a much wider range of products than in the past: people around the world are now living substantially longer and healthier lives than at any point in human history.

The national balance of payments

Economists record the interplay between current consumption and the transfer of assets associated with future consumption in the national *balance of payments* through the *current account* and *capital account*, respectively. The current account is analogous to a household's annual income minus expenses, while the capital account is the analogue of the resulting net change to household savings minus debt over the year. The diagram below details the composition of each. Because of the way they're defined, it's always true that:

Current account + Capital account = 0

The current account records the net income from exports and imports, investment returns and international transfers of various sorts. The capital account covers the three avenues by which foreign savings are invested in Australia plus the net impact of central bank international transactions (the *Reserve Account*).

Current account

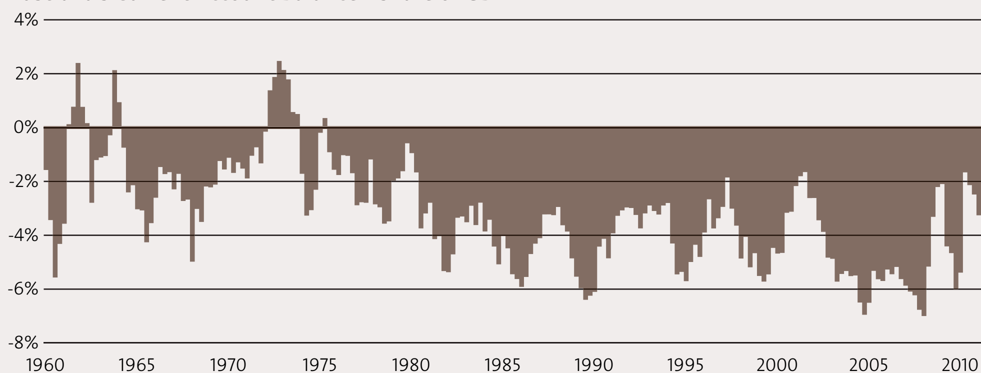
= balance of trade (exports – imports)
+ net income from investments (bonds, dividends etc.)
+ net transfer payments (aid, reparations, remittances etc.)

Capital account

= net foreign direct investment (long-term capital investment)
+ net portfolio investment (bonds and equities)
+ net other investment (bank deposits and loans)
+ Reserve Account (central bank operations)

Note: The direction of the arrows is arbitrary, except that they point in opposite directions.

Australia's Current Account Balance – share of GDP



Source: ABS 5302.0

Moreover, the growth of international trade has tended to make individual economies more, rather than less, resilient, as the negative shocks individual economies experience from time to time can be offset by positive shocks experienced elsewhere.

In any given year, it's vanishingly unlikely that the value of a country's imports will precisely equal that of its exports. Instead, it will record either a trade deficit or a surplus. But there are no free lunches—compensating transfers of debt (promises of future payment) or other assets must balance the ledger. Because debt and assets give rise to future income, countries with a trade surplus are deferring consumption, while those in deficit are swapping future consumption for current consumption. The box outlines how these and other compensating transactions are accounted for in what are known as the national accounts.

Until very recently, Australia has tended to record substantial trade deficits (and continues to record a current account deficit). At first glance, that might appear to be a matter for concern. Surely it must be both short-sighted and unsustainable to fund current consumption—effectively our standard of living—through debt and the sale of assets? Selling or hypothecating the family silver is not normally sustainable. But that's not necessarily the case.

... there are good reasons for countries with untapped natural resources or underdeveloped industrial plant to borrow money for productivity-increasing investments.

Just as there are gains to be had from economic specialisation, there are analogous gains possible from shifting consumption and production over time and between locations. For example, it might be prudent for countries with young populations to save for the day when they grow old. Equally, there are good reasons for countries with untapped natural resources or underdeveloped industrial plant to borrow money for productivity-increasing investments. Indeed, in much the same way as firms and individuals can sensibly either save or borrow depending on their circumstances, so it is for countries at different stages of their economic and demographic development.

One person's savings are another's capital. In a closed economy, the availability of capital for investment is limited by the amount of domestic savings. In an open economy, foreign capital can be used to boost investment without reducing current consumption. Used prudently, foreign-sourced capital can accelerate economic growth and create higher paying jobs than would be possible using domestic savings alone.

A final benefit of relying on foreign-sourced capital is important for Australia, but more subtle. As will be shown below, a substantial share of our exports consists of commodities whose prices are subject to large fluctuations. When prices are high, our economy does well, as it has in recent years; when they fall, we suffer. Foreign ownership of our export assets spreads both the pain and the gain, as part of each upswing or downswing is shifted on to the foreign owners. At the same time, the fact that foreign owners finance, say, a new mine frees Australian savings (think superannuation) for investment in other assets, including assets overseas. So that means that when our export prices fall, and our exchange rate with them, the income loss to Australians is cushioned by the greater value of income from overseas.

In other words, foreign lending and borrowing not only allow us to manage investment and consumption over time; they also allow us (and other countries) to better spread the risk they involve.

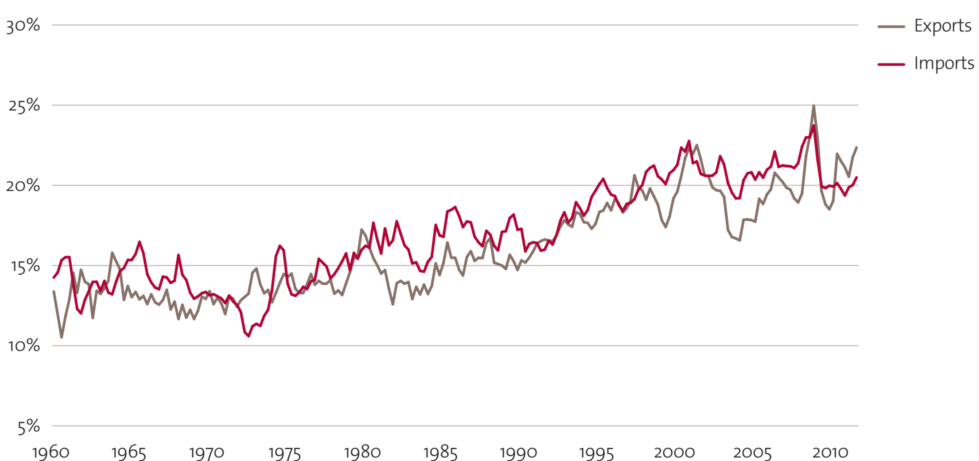
Of course, there's no guarantee that international capital flows will invariably lead to gainful outcomes. As the 2008 global financial crisis and 2011 European debt crisis demonstrate, neither the private sector nor sovereign governments can be relied upon to always make good use of other people's money. Fortunately, the story for Australia, to which we now turn, is more encouraging.

Australian trade and investment

Over the past half century, Australian trade has grown from around 14% of gross domestic product (GDP) to 21%; exports and imports have remained similar in scale. In Figure 1, note the substantial upswing in trade following the liberalisation of the economy in the mid- to late 1980s and the levelling off from 2000 onwards. Despite the broad correlation between imports and exports, imports exceeded exports in four out of every five years. As expected, the shifting balance of trade was reflected in movements in the current account balance over the period.

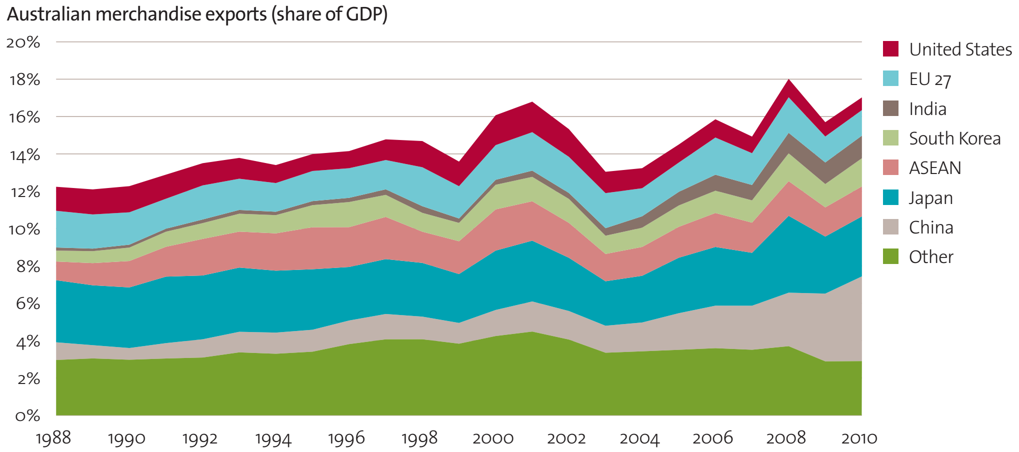
Australian merchandise exports and imports by trading partners for the 1988–2010 period appear in Figure 2. Broadly speaking, the relative share of trade going to particular countries has been surprisingly steady, with a couple of important exceptions. First, since the mid-2000s, China has accounted for a growing proportion of Australia's exports, helping to compensate for the longer term decline in the share of exports going to Japan, the US and 'other' destinations. Second, over the past two decades, rising imports from China and ASEAN countries have slowly displaced imports from Japan, the US and the European Union. Note, however, that Australia's trade with China is only part of a much larger and diverse pattern.

Figure 1: Australian exports and imports as a percentage of GDP, 1960 to 2010 (current prices)



Source: ABS 5368.0

Figure 2: Australian exports and imports as a percentage of GDP, by country, 1988 to 2010



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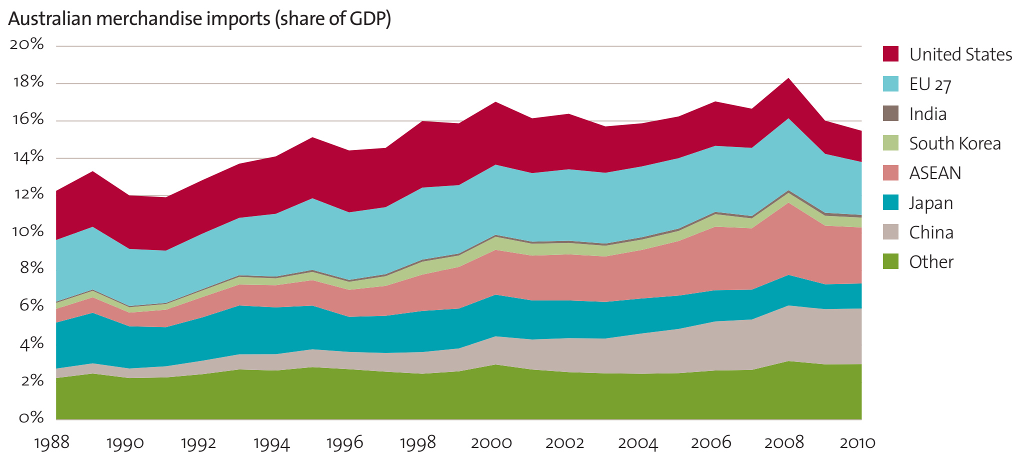
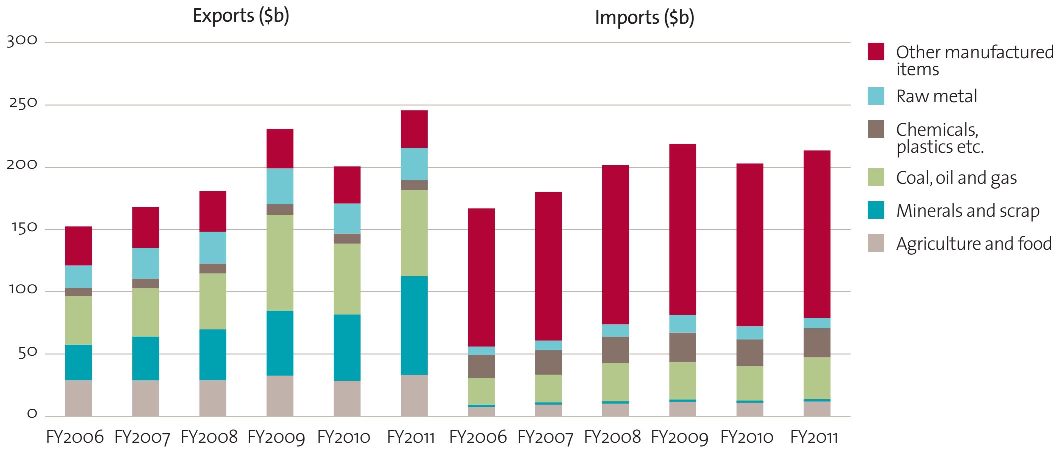


Source: ABS 5368.0

Figure 3 shows the composition of Australian merchandise trade over recent years. Consistent with the notion of comparative advantage, our imports and exports occur largely in different sectors. We tend to export raw materials and import manufactured goods. Perhaps surprisingly, such pronounced specialisation is uncommon among developed nations. Instead, developed economies tend to also interchange large volumes of similar items that are differentiated by brand name—so-called 'differentiated trade'. For example, Sweden sells Saab automobiles to Germany, while Germany sells Audi automobiles to Sweden. Not so for Australia. Our imports and exports strongly reflect the underlying differences in natural and other endowments—labour, land, geology, technology—between us and our trading partners. Coupled with the tyranny of distance, the absence of (typically high value-added) differentiated trade helps explain why Australia's ratio of trade to GDP is the third smallest in the OECD, with only the similarly geographically isolated US and Japan trading less than us.

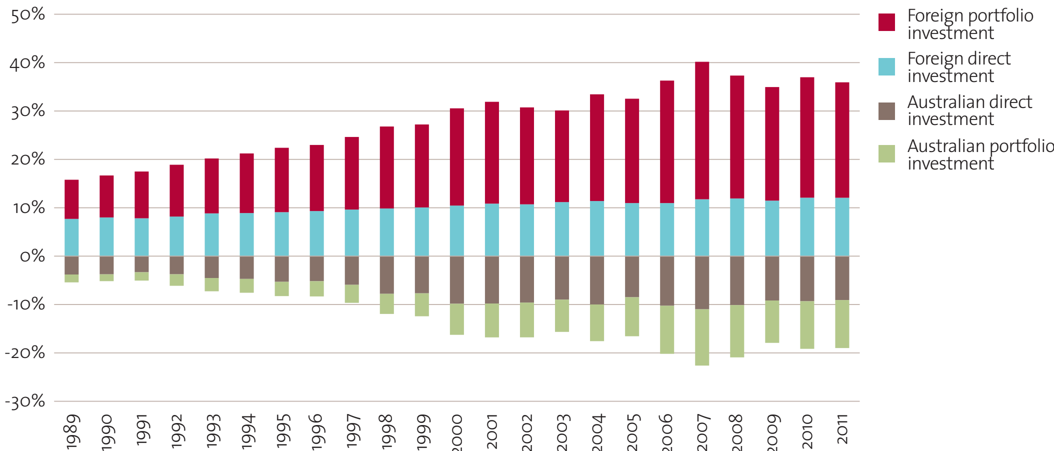
The steady growth in Australian trade during the 1990s was accompanied by an even more rapid expansion of both inwards and outwards foreign investment. Figure 4 shows the growth of accumulated foreign investment as a share of Australia's capital stock (production assets such as factories, equipment and vinestock) from 1989 to 2011 (official liabilities, reserve assets and financial derivatives aren't included). An alternative way to track the accumulation of foreign investment is to plot it as a percentage of annual GDP. However, because the ratio of capital stock to GDP has remained remarkably constant (at about a third) over the past 20 years, the resulting graph has essentially the same shape. Figure 4 divides investment into the categories of 'direct' and 'indirect'. *Foreign direct investment* (FDI) arises when the investor has some influence over the firm's decision-making, which is usually assumed to occur when ownership exceeds 10%. Investment is termed 'indirect' when the investor has either an insufficient stake in the firm to exercise influence over its decisions or invests through an intermediate entity, such as a bank.

Figure 3: Australian exports and imports, by industry, 2006 to 2011 ($ billion)



Source: DFAT 2011

Figure 4: Australian foreign investment as a share of total capital stock, 1989 to 2011

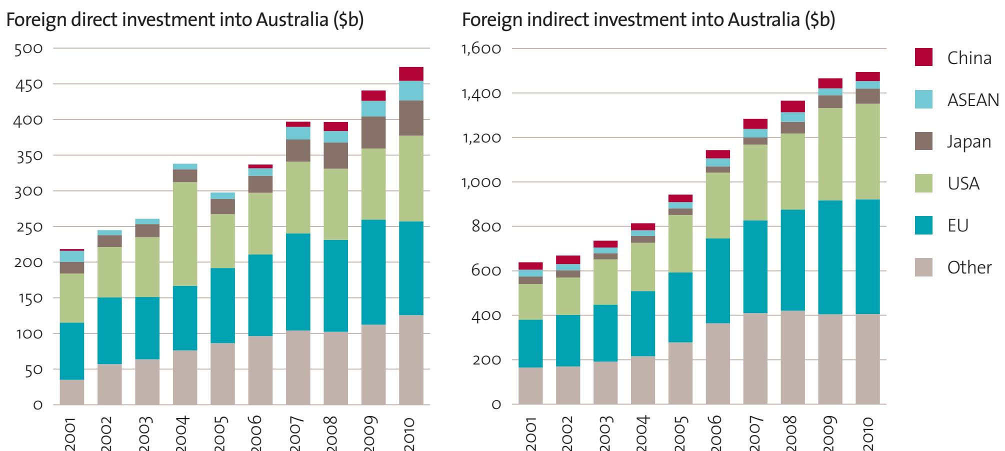


Source: ABS 5302

Looking at Figure 4, it's apparent that foreign investment growth, like imports and exports, slowed around 2000. Since then, growth has been uncertain, with the foreign share of capital stock falling in the wake of the 2008 financial crisis. Note that most of the growth in both inward and outward foreign investment has taken the form of portfolio investment, and that the share due to FDI has changed little over the past decade. Australia has comparatively low levels of FDI in both directions; our inwards FDI as a share of GDP ranks 22nd out of 35 OECD countries, while our outwards FDI ranks 17th.

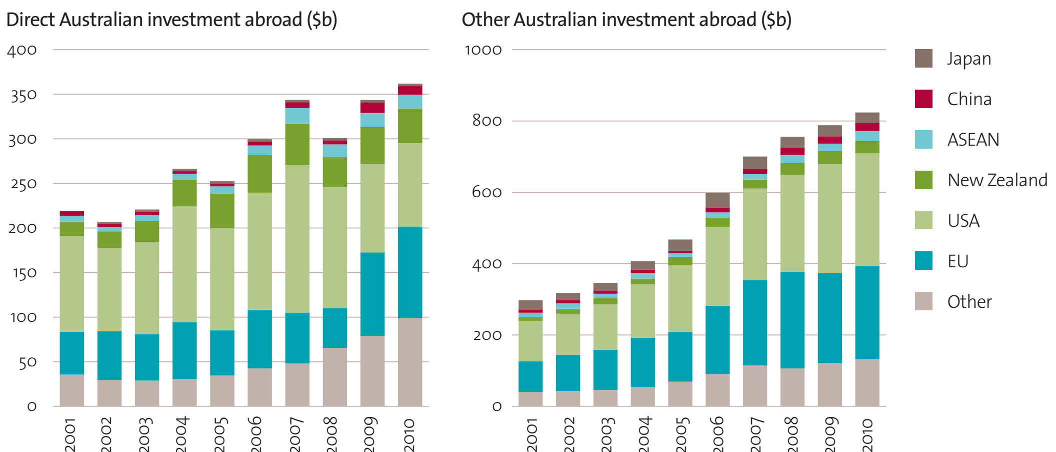
In contrast to Australia's pattern of international trade, which is increasingly with developing countries, our inwards and outwards foreign investment is predominantly with other developed Western economies—in particular the US and European Union. China, ASEAN countries and Japan play only a relatively small role in our investment partnerships. One reason for this is that FDI has historically been an important way of importing technology into Australia—think of motor vehicles or chemicals—and so naturally involves countries at a high level of technological development. As shown in Figure 5, the patterns of inward and outward Australian foreign investment have been similar, even though their scales vary substantially.

Figure 5: Foreign investment in Australia, by source, 2001 to 2010



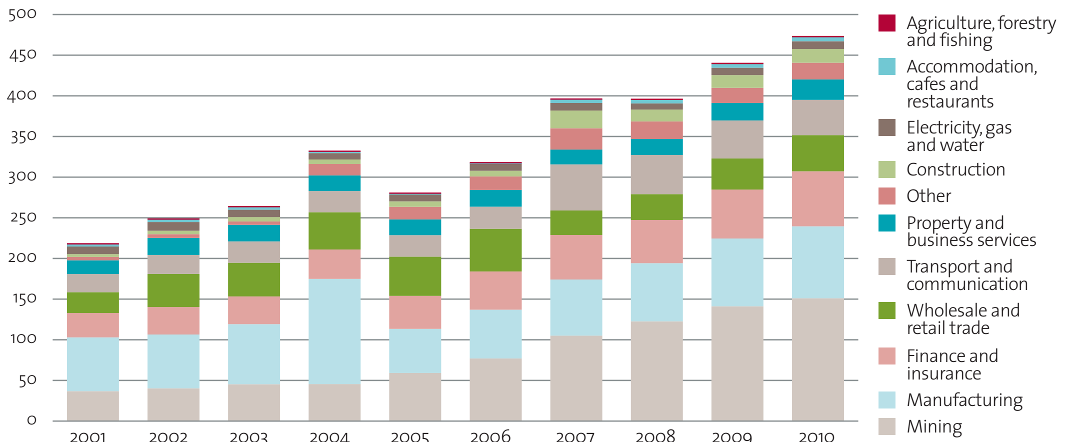
Source: ABS 5352 *Source: ABS 5352*

Australian foreign investment, by destination, 2001 to 2010



Source: ABS 5352 *Source: ABS 5352*

Figure 6: Accumulated foreign direct investment in Australia, by industry, 2001 to 2010 ($ billion)



Source: ABS 5352

Figure 6 graphs accumulated FDI in Australia by industry sector. Most noteworthy is the more than threefold increase to mining over the past decade, to its current value of just on $150 billion. Australia's outward FDI (not shown) is similar, except that activity is much more concentrated into the three largest categories. In total, more than 75% of Australian-owned FDI abroad is in mining, finance and insurance, and manufacturing.

Having surveyed the economics of globalisation and detailed the patterns of Australia's trade and foreign investment, we're now ready to explore the consequences of Australia's economic engagement with the world for our national security. The next two sections explore that question in the context of trade and investment, respectively.

Australian trade and geopolitics

It's simply not true that trade and strategic affairs run on entirely separate tracks. A few examples are sufficient to show the long and varied interplay between geopolitics and trade:

- In 1809, the United States imposed a trade embargo on Great Britain in response to harassment of US vessels during the Napoleonic wars.
- The 1941 Japanese invasion of French Indochina led to an oil embargo by the United States, which in turn led to the Japanese attack on Pearl Harbor.
- In 1966, Sweden embargoed the export of arms to Australia and the United States over the Vietnam conflict.
- Trade sanctions imposed on Iraq in 1991 caused Saddam Hussein to abandon attempts to develop weapons of mass destruction and severely debilitated Iraq's armed forces.

Today, trade restrictions are routinely used to try to coerce countries into changing their behaviour. At present, Australia is enacting sanctions imposed by the UN Security Council against twelve countries and autonomous sanctions against another eight—all of which involve trade restrictions of some sort. Given the interplay between geopolitics and trade, it's worth asking what the strategic consequences of Australia's international trade profile might be.

There's little point in attempting a generic answer. For better or worse, it's trade with China that's at issue. As has so often been observed, our largest trading partner (China)

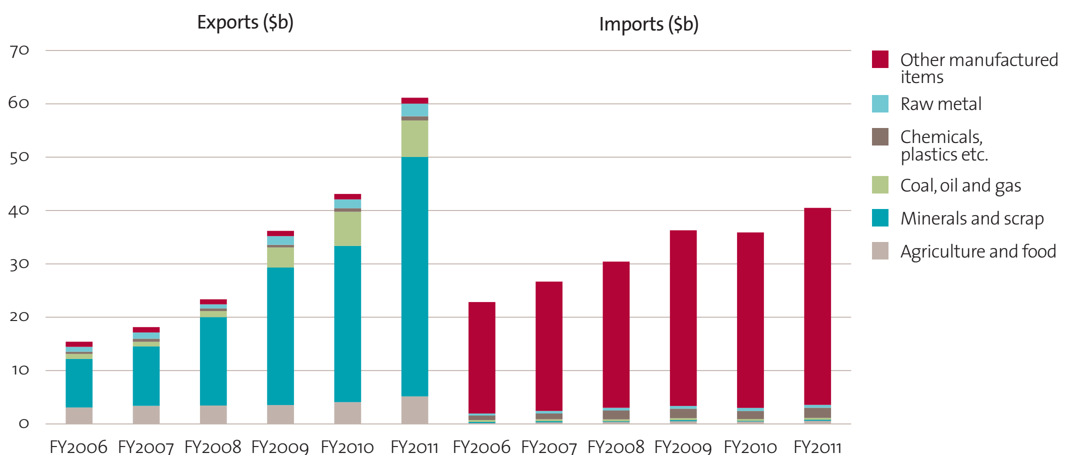
and our key military ally (the United States) are strategic competitors. This concern was highlighted recently in media commentary following the visit of US President Obama to Australia in late 2011.

A common response is to simply observe that the United States' economic relationship with China is actually closer than Australia's. While that might sound reassuring, it only really tells us that things are more complex than we perhaps first thought. Concerns about trade with China deserve to be examined on their merits by asking under what circumstances, and by what mechanisms, could our strategic and economic interests run afoul of each other?

Given the historical precedents listed above, one possibility is that China could impose trade sanctions on Australia if, for example, we decided to support the US during a future US–China crisis. Specifically, China could cancel imports from Australia and seek alternative suppliers. But, as serious as that might sound, it would ultimately be ineffective. Trade sanctions only work when a sufficient number of countries act in unison to deny the target alternative customers or suppliers, as the case may be. Since China would almost certainly be alone in imposing sanctions on Australia, the impact would be limited to a near-term disruption. The critical point is that the vast bulk of Australian exports to China are *commodities* (see Figure 7). That is, our exports are mostly goods that are widely traded on the global market and easily substituted. It's not like we're selling wasabi to Japan or haggis to Scotland.

If China were to rapidly shift to alternative sources for its commodities, total global supply and demand would be unaffected and new opportunities for Australian exports would inevitably open up. That's not to suggest that the transition would be easy or costless; exporters would cry blue murder as their assets sat idle during the time it took for new markets to be found. For a time, those whose livelihoods depend on commodity exports would need to tighten their belts. The near-term impact on the Australian economy would be substantial. Nonetheless, following a period of substantial disruption, a new pattern of trade would be established in which Australia continued to play a role. It would be a game of musical chairs, but a game in which no chair is ever removed.

Figure 7: Australia–China trade, 2006 to 2011 ($ billion)



Source: DFAT 2011

In the meantime, the costs incurred by China would be substantial. Replacing Australia as a supplier would be difficult. We currently supply 40% of China's demand for iron ore. What's more, Australia is the world's largest producer of bauxite, rutile and zircon, and the second largest of iron ore, gold, lead, lithium, zinc and manganese ore, and the third largest of uranium. On top of that, we hold the world's largest or second largest reserves of bauxite, brown coal, copper, gold, iron ore, lead, nickel, niobium, rutile, tantalum, uranium, zinc and zircon. Inevitably, China would face higher costs in sourcing all of those commodities because it would have to secure increased quantities from more distant or otherwise less efficient producers. Moreover, having shown itself to be an unreliable customer to Australia, it would have to pay those sources a premium to compensate for the greater risk they would now bear. As a result, its terms of trade—the ratio of the price of its imports to the price of its exports—would worsen, adding to whatever costs the wider crisis was imposing. Overall, continuing the industrial development of a country with 1.3 billion inhabitants without access to Australia's mineral resources would be easier said than done.

A hostile cessation of trade by China in an attempt to coerce Australia would also hold additional risks for China beyond the problem of finding new suppliers. Not only would a trade ban severely damage Beijing's reputation as a reliable customer, China might also face trade countermeasures from Australia and others, which, given the context, would probably include the United States. Indeed, an embargo on resource exports from Australia would affect not just Australia but the foreign firms that have invested tens of billions of dollars in our resources sector.

For those reasons, China might opt to steer clear of precipitous action and instead slowly shift its imports as contracts expired and its demand grew. While such a move wouldn't work as a coercive tactic because of the extended timeframes involved, China might do so anyway if it lost confidence in Australia as a reliable supplier because of our closeness to the US. That is, China might diversify its sources of supply in an attempt to make itself less vulnerable to economic coercion.

There's little doubt that security of supply weighs heavily on the minds of Chinese strategists. Diligent students of history that they are, the Chinese are certainly aware of the 1941 US oil embargo on Japan. And although diversifying supply would be of little help to China in the event of an outright naval blockade, it could mitigate the impact of an incomplete embargo involving Australia. Beijing's preoccupation with resource security is deep and abiding. That's why it's investing heavily in a bluewater navy, establishing port facilities across the Indian Ocean, and looking for ways to avoid the maritime bottlenecks between the Indian and Pacific oceans. Whether or not that's going to be a successful strategy for it is open to question, but that's what it's doing.

China's preoccupations needn't be our concern, at least as far as trade goes.

China's preoccupations needn't be our concern, at least as far as trade goes. If it were to diversify its sources of supply away from Australia, the long-term result would still only be a rearrangement of customers and suppliers. As long as we remain an efficient and reliable supplier of commodities, we'll find customers for our exports. More bluntly, if China decides not to buy our minerals and energy, someone else will.

That's not to say it wouldn't have a long-term impact. After all, world supply would increase as China helped new sources to develop, so prices would fall. But if there's a business

case for China to expand global supply, we should expect it to do so irrespective of strategic concerns. Moreover, there are likely to be other factors impelling Chinese supply diversification: indeed, it's likely that even without any strategic concerns China might want to diversify so as to reduce its vulnerability to factors such as Australian industrial relations. Indeed, that was a major reason for the efforts of Japanese buyers to limit their reliance on Australian sources in the 1970s and 1980s. As a result, the best way to deal with this possibility is to ensure that we remain low-cost and reliable suppliers, thus minimising our vulnerability should world prices fall.

... there's one scenario in which Australia's economic and strategic relationships would be brought into sharp contrast: acute tensions or an outright armed conflict between China and the US.

But even if the risk of Chinese trade sanctions is limited, there's one scenario in which Australia's economic and strategic relationships would be brought into sharp contrast: acute tensions or an outright armed conflict between China and the US. Such a development would disrupt trade and, depending on its duration and outcome, potentially do great damage not just to Australia but to the global economy. As serious as that prospect is—and it's dire—it doesn't present a dilemma for us today. It would make no sense to forgo the opportunity to trade with China simply because that trade might be disrupted at some point in the future. Indeed, if it did make sense, we should also be reassessing our trade with Japan and South Korea, given the overall vulnerability of North Asian trade to disruption by a US–China conflict. But doing that would be like deciding to remain unemployed rather than accepting a job because of the possibility that the job might cease to exist at some point in the future.

It would make even less sense to distance ourselves from the United States strategically in the vain hope, and with the dubious goal, of continuing to trade with China during some future trans-Pacific conflict. Apart from not being able to evade the inevitable US naval blockade, we'd have to sacrifice trade with the United States and its Asian and European allies if we took China's side. As Figures 2 and 5 clearly show, that trade far outweighs our economic engagement with China.

In the event of war, our strategic and economic interests would be simultaneously threatened, with no possibility of surrendering one to bolster the other. The only lesson to draw from contemplating the consequences of great-power conflict in Asia is that we should be working diligently to avoid such a catastrophe. That might demand that we adapt our alliance with the US to take account of the changing strategic landscape—but that has absolutely nothing to do with preserving our economic relations with China.

Foreign investment and national security

Foreign investment provides a potential mechanism for geopolitical coercion. Specifically, recipients of foreign investment can impose costs on investors, and those costs can be used coercively or even to directly limit another country's freedom of action.

Costs can be imposed in a number of ways. The most common tactic is to 'freeze' the assets of another country or its ruling regime. Recent examples of countries that have lost control of their offshore assets include Libya and Liberia in 2001, Iraq in 2003, Congo and Sudan in 2004, Cote d'Ivoire in 2005, North Korea in 2006, Lebanon and Burma in 2008,

Zimbabwe in 2009, Iran in 2010, and Libya and Syria in 2011.

Foreign assets can also be seized outright. Although that was a common tactic during the 20th century—particularly during the period of decolonisation following World War II—the intent was more usually economic than geopolitical.

Finally, and more generally, foreign firms are inherently subject to a range of sovereign risks such as higher taxes and regulations that could, in principle, be used coercively, although an example is hard to find. More worrying is the risk that foreign firms and their employees might be subject to politically motivated harassment in periods of heightened geopolitical tension, especially in countries where the rule of law is weak or subject to government manipulation.

If anything, foreign investment makes us more secure by giving other countries a vested interest in our continued economic success.

Looking at the pattern of Australian foreign investment (see Figure 5), it's clear that the substantial majority of Australia's inward and outward investment is with countries with which we enjoy longstanding friendly relations, with the remainder spread very thinly across a large number of countries. So whatever vulnerability Australia might have due to inward foreign investment is slight. If anything, foreign investment makes us more secure by giving other countries a vested interest in our continued economic success.

More generally, as a recipient of substantial net foreign investment, we would seem to have greater leverage over the source countries than they have over us. After all, the assets are largely immobile and hence potentially subject to Australian Government control. It's precisely that vulnerability, which foreign investors bear, that makes it essential to maintain our reputation as a country where foreign investors are treated fairly and predictably—that is, to limit the sovereign risk associated with investing in Australia and hence ensure that little or no sovereign risk premium is required by investors when they allocate capital to Australian projects.

However, several additional considerations arise from FDI into Australia. In part, they explain why incoming FDI is regulated by the Australian Government (see the box). Those concerns are examined below. Purely economic issues, such as the potential for foreign speculators to drive up real estate prices, have been dealt with elsewhere and aren't canvassed again here. Instead, the focus is on matters relevant to Australia's national security.

Monopolies and cartels

Like domestic acquisitions and mergers, transfers of ownership to foreign entities can create monopolies over particular goods, or increase the likelihood of cartels emerging by reducing the range of producers that can be relied upon to compete. The imperative to guard against such outcomes goes beyond the obvious desire to avoid paying monopoly rents: national monopolies over certain goods can give countries both strategic advantages and coercive options.

For example, China produces over 90% of the global supply of the rare-earth elements needed for semiconductor manufacture, and it's commonly held that Beijing has at times artificially restricted supply to drive up prices. It's not surprising, then, that Australia hesitated over the sale of a controlling interest in local rare-earth producer Lynas Corporation Ltd to the state-owned China Non-Ferrous Metal Mining (Group) Co. in 2009. And well

Australia's regulation of foreign direct investment

Under Australia's foreign investment policy and the *Foreign Acquisitions and Takeovers Act 1975*, the Australian Government regulates foreign direct investment into Australia, including the acquisition of existing assets and the creation of new business operations. Other legislation includes specific requirements, restrictions or both on the ownership of banks, airports, international airlines, ships and Telstra. Those requirements are factored into the examination of foreign investment proposals, which are considered on a case-by-case basis (except for real estate, where standard conditions generally apply). The Treasurer has the power to reject or to apply conditions to proposals if he judges them to be contrary to Australia's national interest.

The Treasurer is advised by the five-person Foreign Investment Review Board (FIRB), which has four part-time private sector members and a full-time Treasury official. As necessary, the FIRB consults other government agencies and statutory bodies, such as the Australian Competition and Consumer Commission, and various law enforcement agencies.

Although no definition of the 'national interest' is provided in legislation, the government takes account of national security, competition, economic and community impact, other government policies and the character of the investor in reaching a conclusion. In addition, the government says that it 'recognises community concerns about foreign ownership of certain Australian assets' and considers 'these concerns when assessing Australia's national interest'. It's not surprising, therefore, that proposals sometimes may be perceived to have been rejected because of adverse public sentiment. The proposed acquisition of ASX Limited by Singapore Exchange Limited in April 2011 was the first business application blocked by the Australian Government since a proposed takeover of Woodside Petroleum Limited by Shell in 2001.

Potential private foreign investors are required to notify the government if they plan to acquire an interest of 15% or more in an Australian business or corporation valued at $244 million or above (indexed annually on 1 January). All residential real estate proposals require notification, as do investments of 5% or more in the media sector. All proposals for direct investment, new businesses and land acquisitions by foreign governments and their related entities require notification regardless of their value.

The government undertakes to respond to proposals within 30 days, with the possibility of a 90-day extension. In 2009–10, a total of 4,401 proposals valued at $139.5 billion were approved, of which 3,897 involved real estate. Only three proposals were rejected during the year, all involving real estate. Despite the relatively small number of rejections, it's difficult to assess how much the current framework discourages investment. The figures above don't include applications withdrawn during the review process or, of course, proposals that might have been made under a different framework.

In 2011, the OECD ranked Australia 39th out of 50 countries in terms of FDI openness, but that ranking needs to be seen in context: we scored 0.128 on a scale running from 0.0 (open) to 1.0 (closed).

we did, because there's more at stake than the price of rare-earth minerals. In late 2010, China blocked rare-earth shipments to Japan to try to force the release of a Chinese trawler captain arrested by Japanese authorities in contested waters. Beijing was using its market power for geopolitical purposes. In April 2011, Australia agreed to a Japanese bid for a substantial (though non-controlling) share in Lynas Corp., which was followed quickly by a long-term contract that will satisfy 25% of Japan's rare-earth needs for the next decade.

Crime and misconduct

After the extraordinary misconduct by the Australian Wheat Board last decade, and that allegedly involving a subsidiary of the Reserve Bank of Australia more recently, Australia can't claim to have an unblemished record when conducting business overseas. Be that as it may, foreign acquisitions still warrant a degree of caution about the background and character of the purchasers. Australia's review process takes this into account. A further complication arises when an acquisition offers the possibility of transnational fraud.

One example is transfer pricing, whereby a foreign firm sells goods below market price to a related entity in its home country with the goal of evading Australian tax. Suspicions are sometimes raised when a foreign consumer purchases a stake in one of its suppliers—for example, when a foreign steel producer buys a share in an Australian firm that exports iron ore. But there are also quite legitimate reasons for such an acquisition, including greater surety of supply for the producer and as a natural hedge against fluctuations in the price of the exported good. Moreover, if the firm is originally Australian owned, the acquisition price will usually capitalise the profit that it would otherwise have obtained through continuing arm's-length sales, although the differential tax treatment of capital gains and company income means that this may still reduce the tax payable in Australia.

Fortunately, because a large share of Australia's exports are commodities (see Figure 3), it's difficult for transfer pricing to be used to avoid Australian taxes, given the availability of robust market-based price benchmarks and readily measurable export volumes. In more subtle ways, conflicts of interest can sometimes arise due to foreign acquisitions—for example, involving price negotiations between related parties—but there's little evidence that these are major concerns. Where they might be, they can be mitigated by imposing conditions on the management and governance of firms, and if necessary by limiting the extent of foreign ownership.

Secrets and espionage

Australia's defence force and intelligence agencies rely heavily on the private sector for equipment, support and the development of technology, but foreign ownership of firms working in defence industries isn't necessarily at odds with our security. In fact, four of the five largest defence firms operating in Australia are foreign owned (and the other is owned by the government). Not surprisingly, the four are all subsidiaries of the US and European corporations that we buy most of our military equipment from anyway. Rather than reducing our security, this arrangement strengthens our defence by allowing access to defence technologies from around the Western world. There's no point discussing the potential sale of the major firms supporting our defence and intelligence effort to entities inimical to our interest. It would neither be attempted nor allowed.

Nonetheless, there are circumstances in which foreign acquisitions could compromise our security. For example, a large number of small and medium-sized firms support the defence and intelligence sector, and some in the civil sector possess dual-use technologies that could aid the proliferation of weapons, contrary to our interests and

international responsibilities. In much the same way that exports from those firms are carefully regulated, so too is their potential foreign ownership. It's for this reason that the Department of Defence—the agency responsible for both defence industry policy and defence exports controls—is sometimes consulted during the foreign acquisition review process.

Foreign ownership of assets seemingly unrelated to defence and intelligence can potentially damage our security if it allows espionage against either official or commercial targets in Australia. A recent example concerned the proposed sale of most of OZ Minerals assets to China Minmetals, a state-owned Chinese company, in 2009. The sale was blocked by the government on national security grounds until the Prominent Hill Mine, which is within the Woomera Prohibited Area in South Australia, was removed from the package. The sale went ahead only after the removal. It's not clear how the Chinese could have exploited the site for espionage; apart from being 150 kilometres from the weapons test range, it's an operational mine with around 800 Australian workers. Perhaps the decision reflected the government's extremely low appetite for risks related to national security. Whatever the reason, for our purposes it demonstrates both the principle and the process involved in the foreign acquisition of assets with potential national security implications.

Another area where foreign acquisitions can arouse national security concerns is the sale of critical infrastructure. The proposed 2006 sale of port management contracts at six US ports to a state-owned United Arab Emirates firm gave rise to a public fight between the White House (supporting the sale) and the Congress (opposing the sale on a bipartisan basis). Opponents argued that port security would be compromised if the deal went ahead. Eventually, the Congress prevailed and the contracts were transferred from the existing British owner to a US company. The recent decision to exclude Chinese telco Huawei from tendering to supply equipment for the National Broadband Network (though not actually a foreign acquisition) provides a further example of the sensitivities surrounding critical infrastructure.

Food and resource security

Concerns are sometimes raised that Australia risks losing control of the basic resources necessary for survival by selling assets to foreign interests. Recently, questions arose about our food security in the light of foreign purchases of rural assets. One concern was that a significant share of productive rural land may have gone into foreign hands through the piecemeal acquisition of a large number of assets valued below the threshold for FIRB review. In response, the government commissioned research into the extent and impact of foreign investment in rural land and agricultural assets. Subsequent work by the Australian Bureau of Statistics revealed that 99% of agricultural businesses, 89% of agricultural land and 91% of water entitlements for agricultural purposes in Australia are entirely Australian owned.

Even if the proportions of Australian ownership had been substantially lower, it's hard to see why Australia should worry about food security. The most recent official estimate for the value of agricultural and fisheries production (excluding wool and cotton) stands at $46.2 billion, of which $30.6 billion is slated for export. In other words, we produce almost three times more farm product by value than we consume. Moreover, our annual production of around 50 million tonnes of cereals, grains and sugar is enough to satisfy the calorie requirements of each and every Australian more than seven times over. That doesn't include

the 1/2 kilogram of meat and 1 litre of milk produced on average per person each day. If that's not enough, we harvest enough rock lobsters to each have a 1-pound (425-gram) crustacean every year on our birthday. Bon appétit!

The underlying notion that foreign ownership of productive assets... somehow puts them beyond our control is simply incorrect.

Misguided concerns about food security extend beyond ignorance of the data. The underlying notion that foreign ownership of productive assets—be it mines, energy or farms—somehow puts them beyond our control is simply incorrect. Section 51 of the Constitution explicitly gives the Australian Parliament the power to regulate exports and to enact laws that apply to foreign corporations operating in Australia. Australia isn't unique in this regard: domestic and foreign investors in every country face the sovereign risk inherent in the powers of the state. As you'd expect, governments tend to be very careful about imposing new costs and regulations because of the possible impact on future trade and investment. But in the event of an emergency, few governments (certainly not democratic governments) would abandon the security of their citizens to placate foreign interests.

Sovereign wealth funds and other sovereign-controlled entities

Australian policy on foreign investment is explicitly cautious about purchases by state-controlled entities (see the box). Following an increase in investment proposals from Chinese firms, the Australian Government released guidelines for investment by state-controlled entities in February 2008. The concern, voiced by the Treasurer, was that:

> investors with links to foreign governments may not operate solely in accordance with normal commercial considerations and may instead pursue broader political or strategic objectives that could be contrary to Australia's national interest.

The remainder of this section examines the risks that the Australian Government sought to guard against with its expanded foreign investment guidelines. The key question is about what's meant by the terms 'political' and 'strategic' in the Treasurer's announcement.

If the word 'strategic' is being used to describe an investing country's economic strategy for development, the implied risk would be that a state might exploit its ownership of foreign businesses to give preferential treatment to counterparties in its home market. Possibilities would include transfers of technology and directed investment back into its own national economy.

While such circuitous strategies are conceivable in principle, no examples come to mind. Moreover, such possibilities are arguably no more concerning or inefficient than the acquisition practices of large multinational corporations. More importantly for Australia, it's hard to see how such risks would arise in the resource areas that have dominated recent FDI proposals (for much the same reason that transfer pricing is a manageable concern). Nonetheless, nothing is lost by being aware of such risks, provided that investment is not unduly discouraged.

In the Treasurer's announcement, the alternative meaning of 'strategic' would be as an amplification of 'political': that is, an objective to do with government decision-making rather than commercial

Sovereign wealth funds and sovereign-controlled entities

Sovereign wealth funds

An increasing number of countries are using their excess savings to establish state-owned investment funds known as 'sovereign wealth' funds. The funds are separate and distinct from the reserve foreign funds held by central banks for the purpose of intervention in foreign exchange markets. Sovereign wealth funds tend to make long-term investments with the goal of covering future liabilities (such as an ageing population) or the intergenerational transfer of wealth from one-off sales of national assets (minerals, energy, state-owned enterprises and so on). Sovereign wealth funds are also seen as having the potential to deliver better returns than reserve holdings, and are sometimes viewed as a hedge against shocks to a country's comparative advantage (although that's questionable).

More than $4.7 trillion is held by sovereign wealth funds around the world. The largest funds are held by China ($995 billion), the United Arab Emirates ($627 billion), Norway ($560 billion), Saudi Arabia ($473 billion), Kuwait ($296 billion), Russia ($114 billion), Qatar ($85 billion) and Australia ($73 billion). As large as these numbers are, they're small compared with the global holdings of insurance, pension and mutual funds.

State-owned enterprises

Although most developed countries privatised the bulk of their state-owned commercial assets in the closing decades of the 20th century, many developing countries retain state-owned businesses in a range of sectors. China, in particular, has preserved state ownership in many areas. Estimates vary, but around 50% of China's industrial assets are believed to be state-owned, including most of the larger companies.

Independence

Ownership and control aren't the same thing. Sovereign-owned entities are usually set up with a degree of separation from their owners. If we take Australia's Future Fund as an example, all the signs are that its day-to-day operations are conducted independently of the government. Further confidence comes from the transparency of the fund's operations and the public standing of the individuals who make up its board of guardians.

Many foreign funds and other state-owned enterprises are less transparent and independent of their owners, especially in countries where the rule of law is lax and cronyism occurs. It's known, for example, that the Chinese Communist Party plays a critical role in making senior appointments and decisions in most major Chinese corporations. There's little doubt that the party can direct the operations of Chinese state-owned assets if it chooses to.

outcomes. Academic writing on sovereign wealth funds refers to this possibility more bluntly as blackmail. Call it what you will, anything that constrains the government's decision-making and freedom of action is a national security concern. But how credible a possibility is this?

A hypothetical scenario can shed some light on this issue. Consider a situation in which a foreign state-owned entity holds a controlling interest in a major farming, mining, manufacturing or service enterprise in Australia. Assume, for argument's sake, that it's willing to incur whatever costs are necessary to deliver a political outcome for its owner. What are its options? It turns out that there are very few. Selling the asset in protest against the Australian Government would make a point, but because the asset would continue to operate there'd be nothing lost (from our perspective). Indeed, a fire sale to an Australian buyer would make us better off.

If the goal is to put political pressure on the Australian Government, there's only really one possibility. The foreign government could direct its enterprise to cease operation and let the asset lie idle. Australia would lose tax revenue and Australian workers would be displaced from their jobs. More seriously, any minority shareholders would find their income slashed and their investment devalued. But the costs on the other side would also be substantial—starting with lost revenues. Once it became known that a country was using its direct investments to try to force political concessions, the willingness of other countries and commercial counterparties to accept FDI from that source would plummet.

At this point, it's probably safe to conclude that no foreign power would so egregiously violate international norms as to try to extract political concessions from another country through its commercial arms. The costs would simply outweigh the potential benefits. Nevertheless, let's continue the hypothetical, and assume that a foreign power not only adopted such a course of action, but that its actions extended across a range of assets in Australia. There's no doubt that pressure would quickly mount on the Australian Government to take action, and it would: the assets would be expropriated and returned to production.

The foregoing discussion presumes an extreme scenario. The Treasurer might have more prosaic or nuanced concerns about foreign state-owned companies pursuing 'broader political or strategic objectives', but it's hard to imagine what they might be.

Official debt and foreign money

There's one other type of foreign investment that merits examination: the purchase of government bonds or of the bonds issued by government-owned entities to fund operating deficits.

In recent years, a lot has been written about the accumulation of US bonds in foreign hands. At present, around US$4.7 trillion in US Treasury securities (equivalent to 32% of US GDP) is held outside of the US. The largest share (US$1.1 trillion, or 7.5% of US GDP) is held by China. Whether or not those foreign holdings are an American vulnerability is controversial, and answering that question is beyond the scope of this paper. It's sufficient to point out here that foreign holdings of Australia's official debt are both small and diversified.

In September 2011, foreign holdings of Australian official debt amounted to only $45 billion, equivalent to a mere 3.5% of our GDP. In descending order, the holdings are spread geographically as follows: Europe ($16.2 billion), South and Southeast Asia ($15 billion), North Asia ($6.7 billion) and North America ($2.2 billion). On any reasonable standard, foreign holdings such as these increase the liquidity of Australian official

debt and hence reduce its cost, benefiting Australian taxpayers.

None of this suggests that Australia's debt position should be taken lightly. Not only will future taxpayers have to repay the outstanding principal, but the annual interest payments impose a roughly $2 billion annual opportunity cost on our society. Nonetheless, what matters is that our debts are manageable. Absent an economic catastrophe, there's no prospect of an Australian sovereign default in the near to medium term, and things will remain that way unless future governments reverse the current bipartisan commitment to a balanced budget over the business cycle.

The politics of economic relations

So far, this paper has focused on a relatively narrow question: does Australia's emerging pattern of economic engagement directly limit its strategic freedom of action or compromise its national security? On the whole, it appears that we're in a relatively strong position. There are few avenues open to foreign powers to coerce Australia through economic means, none of which are likely to be ultimately effective.

But there's more to the issue than the arithmetical sum of the explicit commercial transactions in our trade and investment portfolios. Relationships of all sorts—strategic, personal, economic—have implicit as well as explicit components. The explicit components are codified in carefully worded documents, such as treaties and contracts, while the implicit components tend to be both ambiguous and evolving. Take the ANZUS alliance as an example: while the wording of the treaty has remained unchanged for 60 years, the implicit expectations and commitments under the alliance have evolved substantially and continue to do so today.

In much the same way, economic relationships between countries are usually accompanied by implicit undertakings and expectations. Emblematic of such things is the notion of 'friendship'—a diplomatic term-of-art rarely absent from official communiqués. Though never formally defined, it reflects a degree of sensitivity to the interests and preferences of the other party (just as in a friendship between two people). Arguably, Australia's postwar relationship with Japan saw an initially narrow economic partnership expand into a 'friendship' in which each party was sensitive to the other's preferences. No better example exists than the 1992 promise by Prime Minister Paul Keating that Australia would not be a party to any trade agreement directed against Japan.

The question is: will our growing economic interdependence with China lead us to make similar concessions to Beijing in the years ahead—perhaps even strategic concessions? The possibility can't be dismissed. Australia already demonstrates remarkable sensitivity to Chinese concerns about many issues, including human rights and political reform.

Many countries maintain very close economic relations—closer than those between China and Australia—but preserve substantial diplomatic freedom of action across a wide range of issues.

How much further we go is up to us. Nothing's preordained. Many countries maintain very close economic relations—closer than those between China and Australia—but preserve substantial diplomatic freedom of action across a wide range of issues. The diverse and often squabbling European Union provides an

example, as do the members of the North American Free Trade Agreement, not to mention the massively economically interdependent United States and China.

Even in the absence of these counterexamples, caution is needed before projecting Australia's experience with Japan onto our future relationship with China. Japan is many things that China isn't, including a democracy and a US ally. Critically, Australia and Japan have consistent approaches to human rights, political freedom and intellectual property. It's easy for us to be sensitive to Japan's interests because they're broadly aligned with our own interests and values.

China's much more problematic. Few doubt that Beijing wants to drive a wedge between the US and its friends and alliance partners in the Pacific. To that end, China has every reason to emphasise the benefits of economic cooperation when dealing with US allies such as Australia. It isn't a question of coercion or even of persuasion. Rather, China conflates its expectation of 'friendly' behaviour with notions of a healthy economic relationship. The tendency of Australian politicians to take credit for major trade deals only reinforces the perception that trade is contingent on amicable relations.

Be that as it may, Australia's interests are best served by rejecting attempts to conflate economic and other matters, especially strategic matters, but this can be difficult. The prevailing narrative in Australia misconstrues our economic relationship with China. In the public eye, we're highly 'dependent on' and 'vulnerable to' China. Worse still, the ill-founded perception of economic vulnerability creates a real vulnerability to diplomatic pressure. Consider what would happen if China signalled its displeasure with Australia over an issue by cancelling a high-level visit at the last minute (a tactic Beijing has usually reserved for Japanese leaders). A regrettable diplomatic setback would be interpreted by many in Australia as a harbinger of economic doom. The domestic pressure on the Australian Government would be enormous.

Until such time as the government tells a convincing and consistent story about our growing economic interdependence with Asia, it will have to bear the consequences of such misconceptions. The forthcoming White Paper by former Treasury chief Ken Henry on Australia in the Asian century might help things along.

Collateral consequences

Quite apart from the specifics of Australian trade and investment, it's often argued as a general proposition that trade won't just make us wealthier, but also safer and more secure. This section critically examines such arguments. For convenience, 'trade' is used here as shorthand for economic engagement in the broad sense.

Perhaps the most common argument is that because expanding trade goes hand in hand with economic development, trade will make the world more peaceful by hastening countries along the path to democracy and liberal values. There are two assumptions in that argument.

The first is that prosperity is invariably, or eventually, accompanied by the establishment of liberal democracy. However, that type of non-Marxist historical determinism was much more convincing before the emergence of non-democratic 'state capitalism' as an alternative model of social and political order. China, Singapore and Russia all have large, well-fed, middle-class populations, but democracy (as we understand it) remains but a hope in those countries.

Second, the argument presumes that democracies will—by their nature—avoid conflict with one another. Looking back

on a 20th century wrenched by titanic struggles between democracy, communism and fascism, that sounds at least plausible. But the proliferation of democratic states is a relatively recent development, so we have a limited sample from which to draw precedents. And, in any case, there's no guarantee that a foreign democracy will support Australian interests to a greater extent than the autocracy it replaces. In some cases, given the potential for nationalism to overwhelm self-interest, we might need to be careful what we wish for.

An alternative argument removes the intermediate step of democratic government and instead argues that bilateral trade between countries is sufficient to reduce the prospect of war by creating better understanding between the two countries and by raising the economic cost of potential conflict. The fact that World War I brought a cataclysmic end to the first age of globalisation in 1914 shows that, even if both those mechanisms reduce the likelihood of conflict, they may not be sufficient to eliminate it.

Moreover, it's easy to find instances in which economic interdependence results in friction—we need look no further than the tense posturing between the US and China over a range of economic issues. China accuses the US of 'exporting inflation' through quantitative easing, and blames the global financial crisis on lax US Government regulation of American financial markets. Washington accuses Beijing of 'importing jobs' through artificially low exchange rates that create a savings glut, which (to some US commentators) was a root cause of the global financial crisis in the first place. The reality is that both the US and China have reaped substantial benefits from their economic relationship, but that painful political and macroeconomic costs have been incurred on both sides as a result—costs that are much easier to blame on each other than to pay.

Another claimed benefit of trade is that it can help stabilise fragile states by boosting living standards (leaving aside the earlier proposition that rising living standards will *de*-stabilise autocratic regimes). On this basis, we should encourage trade with, and investment in, the small states of the South Pacific. What's more, as far as it's feasible, we should do the same for global troublespots where we and our allies have an interest, like Afghanistan and Pakistan.

... apart from removing impediments, governments are usually poorly placed to create trade and investment where the private sector is disinclined to do so.

Even here, there's a caution: apart from removing impediments, governments are usually poorly placed to create trade and investment where the private sector is disinclined to do so. And even when it's possible to create the conditions for greater economic engagement, there's no guarantee that advantages will accrue. Large resource projects, in particular, have the potential to cause friction—as arose in Bougainville in the 1970s—if the perceived gains aren't spread widely enough.

Finally, there's the proposition that because trade improves our prosperity it allows us to spend more on defence and security. While that's uncontestable, the other side of the coin is that trade also allows our trading partners to do the same. Robert ('Pig Iron Bob') Menzies' struggle with waterside workers in 1938 over the export of scrap iron to Japan resulted from radically different views about whether the shipments were in Australia's national interest. In principle, there's no reason why we couldn't face such a dilemma again.

Surveying the claimed secondary benefits of trade to our national security, it's clear that there are no hard and fast rules. Economic engagement can enhance our security in many circumstances, but might erode it in others—and we mightn't be able to identify which will be the case ahead of the event.

Nevertheless, the overall historical trend indicates a positive correlation between economic development (and therefore trade and investment) and security. Over the decades that globalisation has helped to lift billions of people out of poverty, the world has become a progressively more peaceful place. There's cause for cautious optimism.

Conclusion

Australia's prosperity has been substantially enhanced through our engagement with the global economy, at no cost to our national security.

To the extent that there are security risks in accepting foreign direct investment into Australia, those risks have been acknowledged and are managed through a well-developed process of review.

More importantly, our involvement in international trade provides no credible avenue for foreign powers to force concessions from us. Short of an outbreak of war, our strategic relationship with the United States is fully compatible with our growing economic engagement with China. We don't have to choose, now or in the future, between our economic and strategic interests.

However, perceptions matter. Misconceptions about Australia's economic vulnerability inhibit the government's ability to confidently assert our interests. The forthcoming White Paper on Australia's role in Asia needs to set the story straight.

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Notes

A readable explanation of international trade appears in Helpman (2011).

Trade and investment statistics in this paper have been taken from Australian Bureau of Statistics publications. Additional data has been taken from statistics held by the Department of Foreign Affairs and Trade (DFAT 2011).

Australia's foreign investment regulatory framework is detailed on the FIRB website. A comparison of international regulatory regimes appears in OECD (2011). Kirchner (2008) and Makin (2008) have delivered robust critiques of the regulatory framework.

For a critical analysis of sovereign wealth funds, see Balin (2008).

The examination of the politics of Australia's economic relations owes much to discussions with Graeme Dobell, although the argument and conclusions presented here are entirely my responsibility. See also Dobell (2011).

The idea of links between trade, prosperity, democracy and peace date back to at least the 18th century (see Howard 1977). Ferguson (2005) draws interesting parallels between the current situation and the years preceding World War I. Improving trends in inter-state and intrastate violence have been reported by the Human Security Report Project (HSRP 2011).

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Acronyms and abbreviations

ADF	Australian Defence Force
AEW&C	airborne early warning and control
AWD	air warfare destroyer
FDI	foreign direct investment
FIRB	Foreign Investment Review Board
GDP	gross domestic product
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
R&D	research and development
UN	United Nations

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