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Chinese coercion, Australian resilience

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CHINESE COERCION, AUSTRALIAN RESILIENCE

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KEY FINDINGS

- China's trade coercion against Australia since early 2020 has so far failed to meet its key objectives: to impose substantial costs across the economy and change Australia's national security policy.
- Even as bilateral relations stabilise, Australia should expect punitive measures to remain in place, either in whole or in part, and the cost of them to rise over time as China grows and its market becomes less accessible to Australian producers.
- Australia should work to entrench its position as an indispensable supplier of key commodities to China. This benefits the Australian economy and gives Canberra leverage at a time when Beijing is trying to use trade as a political weapon.

EXECUTIVE SUMMARY

Australians have grown in confidence about the country's ability to withstand economic coercion from China since the imposition of punitive trade measures in 2020. Beijing suspended high-level political exchanges and imposed a range of informal sanctions and trade blockages against Australia in the wake of a series of escalating disputes, culminating in Canberra's call for an independent inquiry into the origins of Covid-19 in April that year.

Two years on, it is prudent to plan on the basis that it is still early days in China's use of trade measures against Australia. Canberra and Beijing resumed ministerial-level dialogue after the election of the Albanese Labor government in May 2022. But given the long-term structural divide between the United States and China, and Australia's position as a strong US ally, Australian governments of all persuasions should assume that China's trade policies against Australia will remain largely in place. Beijing may tactically retreat now and again to fill shortfalls or if it wants for political reasons to present itself as a conciliatory partner. But a solution to the fundamental bilateral political tensions driving trade disruptions is not on the horizon.

The sectors in which bilateral trade with China have continued to prosper are not those in which Australian producers are dependent on China but rather where the two countries are interdependent. Australia cannot find alternative markets to match China for commodities such as iron ore, liquefied natural gas, and wool. Nor can China wean itself off a substantial reliance on Australia as a supplier. For this reason, the core elements of bilateral trade will remain reasonably resilient for some years.

However, absent a huge change in the structure of the Australian economy and its export profile, the longer-term picture for exports to China looks worse. As China's economy grows and its structure changes and becomes less resource intensive, Australia will likely get a decreasing share of a growing pie. Over time, the cost of trade bans and other punitive measures will likely mount as Chinese investment in Australia diminishes and the cost of diversifying from the region's largest economy grows.

Australia has maintained its reputation as a reliable supplier of commodities throughout the downturn in bilateral relations with China. It is imperative that it continue to do so — both to benefit the Australian economy and to maintain leverage of its own. Control over critical commodities carries considerable strategic value, as the role of gas and oil in the Ukraine war has shown.

INTRODUCTION

From economic charm offensive to trade coercion

China is Australia's most important trading partner and largest export destination for a range of high-value exports such as iron ore, liquefied natural gas (LNG), coal, gold, and agricultural products, as well as services such as tourism and education. Collectively, these exports were worth more than \$160 billion annually to Australia in 2020–21, representing a significant contribution to the country's \$1.3 trillion economy.¹

Australia's relations with China reached their peak in late 2014 when China's President Xi Jinping addressed a joint session of the Australian parliament to widespread applause from Members of Parliament. A landmark free trade agreement was signed, a much-anticipated deal that cemented the already strong trade relationship between the two countries.²



Australia's relations with China reached their peak in late 2014 when a landmark free trade agreement was signed. Pictured: Shanghai district, China (Alexander Schimmeck/Unsplash)

At the time, China was willing to offer Australia greater access to its fast-growing market in the hope of securing ties with a key supplier of raw materials and agricultural goods, with the potential extra benefit of diluting the centrality of Australia's security alliance with the United States. Bilateral trade grew rapidly and Chinese investment into Australia soared along with it.

Only eight years later, this flourishing bilateral relationship represents a bygone era. The immediate trigger for the collapse in bilateral relations — although not necessarily the cause — can be traced to the Morrison government’s demand for an independent examination of the origins of Covid-19.³ A week after the former foreign minister Marise Payne’s impromptu call for the inquiry during a television interview on 19 April 2020, the Chinese ambassador in Canberra delivered a sharp rebuke to Australia with a thinly veiled threat of trade retaliation.⁴

In the years leading up to the Covid-19 inquiry call, Australia and China had battled over a multitude of issues, including Beijing’s tightening grip over Hong Kong, its intimidation of Taiwan, its sovereignty claims, and land reclamation in the South China Sea, as well as Australia’s Huawei ban from its 5G network and Canberra’s legislative crackdown on foreign interference, amongst other things.

China also complained about Australia’s use of anti-dumping laws, which it saw as a form of backdoor protectionism running against the spirit of the bilateral trade agreement that had recognised China as a market economy.⁵ The tensions were also a manifestation of structural factors. As China leveraged its growing economic, political, and military power to achieve dominance in the region, Australia joined its key ally, the United States, in pushing back.

In the months following April 2020, Beijing enacted the most comprehensive punitive trade measures it has used against any country in recent history. A raft of punitive measures was applied to a broad range of Australian industries, from barley and wine to coal, lobster, and timber. This has been coordinated through multiple Chinese central government agencies — from the National Development and Reform Commission (China’s chief planning body) and the Foreign Ministry to Customs and the Ministry of Commerce, which handles trade. Those ministries operate at the direction of the highest decision-making councils in China, notably the Politburo.

Understanding the resilience of Australian exports

The question this paper seeks to address is just how resilient these export sectors are, now and into the future, in the face of ongoing tensions with Beijing, especially as no wholesale reprieve of China’s trade measures against Australia is in sight.

In the months following April 2020, Beijing enacted the most comprehensive punitive trade measures it has used against any country in recent history.

The first part of this analysis examines three of Australia's most critical commodities exports that collectively account for more than 75 per cent of the country's exports to China. In 2020–21, Australia's iron ore exports to China were worth \$125 billion, or 74 per cent of total merchandise exports to the country; LNG was worth \$10.8 billion; and coal was worth \$2.2 billion (down from \$13.7

Commodities such as iron ore, LNG, and wool have remained largely untouched by tariffs due to a lack of alternative sources of supply.

billion in 2019–20).⁶ The value of Australian agricultural, forestry, and fisheries exports to China in 2020–21 was \$11.12 billion, accounting for 7 per cent of merchandise exports to the country. These sectors are examined in the second part of this paper, as well as the smaller export industries of beef, wine, barley, wool, education, and tourism.

While multiple sectors have been adversely affected by a mix of formal and informal trade tariffs, barriers, and disputes — as well as

China's Covid-zero policies, which severely restrict its citizens from travelling abroad — the weight and effects of China's measures have been very unevenly distributed across them.

Commodities such as iron ore, LNG, and wool have remained largely untouched by tariffs due to a lack of alternative sources of supply. China's rapid economic recovery and strong demand for energy in the months after the initial Covid-19 outbreak have in fact, at different times since 2020, resulted in record prices for Australian exports such as iron ore, LNG, and coal.

In other sectors, such as wine, meat, and lobsters, China's measures have exacted at times a heavy price on Australian producers. Barley producers found alternative markets but lost the premium prices that Chinese buyers paid. The same goes for thermal coal, which was diverted into other markets after being blocked by China. In many cases, close relations between Australian sellers and Chinese buyers built over decades have been destroyed and will not be easily rebuilt.

Resilience punctured by long-term uncertainty

Although China is by far Australia's largest trading partner and importer of key commodities, it has so far been unable to use this position to create leverage over Australia and influence its foreign policy on terms more favourable to Beijing.

Not only has the Australian government not budged — it has not felt significant public pressure to do so. Numerous polls have shown the Australian public supports the government taking a firm stand against China and not offering diplomatic concessions to secure export markets. But the failure of the trade measures to cause widespread damage across the economy has also eased pressure on Canberra to shift ground.

Former treasurer Josh Frydenberg spoke for many in Australia when he said in September 2021 that the impact of China’s trade measures has been “relatively modest”. Former prime minister Malcolm Turnbull argued soon after the measures were imposed that Australia could withstand Chinese pressure. (In his words, the Chinese did not buy Australian iron ore because “they liked kangaroos”.) Other commentators have suggested that China had “overreached” in punishing Australia.

It is prudent to plan on the basis that China’s politically motivated trade measures may continue either in whole or in part.

The overall macroeconomic impact of China’s trade wrath has been limited. However, it is prudent to plan on the basis that China’s politically motivated trade measures may continue either in whole or in part. Existing measures may not be hurting the overall health of the Australian economy for now. But over time, their cost is likely to get higher as Chinese investment in Australia diminishes and the cost of diversifying from the region’s largest economy grows.

Beijing could still impose a heavy penalty on the Australian economy through additional measures to influence Canberra’s political calculations in the bilateral relationship and more broadly. Much depends on China’s ongoing demand for iron ore, LNG, and coal, which make up the bulk of Australia’s exports.

The iron ore sector’s resilience so far is due to strong Chinese demand and limited alternative supplies. But Beijing has set clear targets to wean itself off overdependence on Australian iron ore by diversifying supplies, changing the way it makes steel, and leveraging its position as the world’s largest importer in order to bring down prices. The same applies for LNG. Although Australia will remain an important LNG supplier, Beijing is actively seeking alternatives, motivated by both politics and economics.

The outlook for coal is murkier for multiple reasons, including the impact of climate change governance on energy policy and problems relating to financing new mines in Australia, no matter the demand. But Beijing’s coal bans have already cost Australian producers — and the Treasury — significant income. Absent a significant change in the structure of the Australian economy and its

export profile, the picture in five years will almost certainly look worse for Australia as the Chinese economy becomes cleaner and less resource intensive.

International students and tourists are also an important source of export income for Australia, and Chinese nationals make up the largest numbers in both categories. Although it is hard to measure the long-term impact on these sectors

Australia has maintained its reputation as a reliable supplier of commodities throughout the downturn in bilateral relations with China.

until normal travel from China is resumed, neither is likely to return to pre-Covid levels for many years, if ever.

Even so, core bilateral trade looks set to remain reasonably strong for some years. The sectors in which Australia appears most dependent on China — iron ore, LNG, and wool — illustrate how the two countries remain interdependent. Both countries would be equally damaged by a rupture in trade in these commodities in the near to medium term.

Neither can the longer-term push towards greater diversification in Australia and China be the whole story. Australia cannot find alternative markets to match China for commodities such as iron ore, LNG, and wool. Nor will China be able to entirely wean itself off a substantial reliance on Australia as a supplier. It makes sense, then, for Australia to nurture interdependence, both to benefit the Australian economy and to maintain leverage of its own.

As the Ukraine war has shown, control over commodities has strategic value as well. Australia has maintained its reputation as a reliable supplier of commodities throughout the downturn in bilateral relations with China. It should continue to do so.

IRON ORE

Iron ore is the most important export earner for Australia. Between 2000 and 2020, Australia exported more than \$620 billion worth of iron ore to China.⁷ In April 2021, the spot price reached the record high of \$238 per ton. For every \$10 increase in iron ore price, the Australian federal government's tax receipts are boosted by \$2 billion.⁸

China's purchases of Australian iron ore have taken on a strategic dimension at a time of geopolitical competition. In the former treasurer Joe Hockey's memoir, he recounts how then president Barack Obama asked former prime minister Tony Abbott to stop selling iron ore to China. Hockey complained furiously in the book, writing: "That is ridiculous. What was the Americans' plan for Australia? Were they going to buy all our iron ore? Those exports were critical, both for the economy and for the federal and Western Australian budgets."⁹



Iron ore is the most important export earner for Australia. Pictured: Iron ore train, Dampier, Western Australia (Eddie Bugajewski/Unsplash)

Exports of iron ore are critical to Australia's political economy. In March 2022, the Western Australian government announced a projected budget surplus of \$5.7 billion, driven by surging iron ore royalties. Western Australia earned about \$10 billion in royalties in the 2021–22 financial year, compared to just \$868 million in 2006–07.¹⁰ Three out of the ten richest Australians also owe their fortunes to iron ore, including Gina Rinehart and Andrew Forrest. Clive Palmer, the seventh-ranked billionaire, is collecting \$500 million a year in iron ore mining royalties from his estranged Chinese partner, the state-owned CITIC.¹¹

Surging commodities prices helped the Australian economy recover to pre-Covid levels of output during the first quarter of 2021, joining a rare group of five other countries including China. The terms of trade — which measures the relative prices of exports and imports — rose 7.4 per cent between January and March 2021 and drove the country's current account surplus to a record high of \$18.3 billion.

Despite trade measures against a spectrum of Australian export sectors, the iron ore industry remains untouched by the current standoff. While ships carrying Australian coal were left stranded in the seas off the Chinese coast, Chinese workers could not unload the Pilbara cargoes fast enough.

Why is Australia's most important export sector being spared from Beijing's trade coercion? And how resilient is the industry in the medium term?

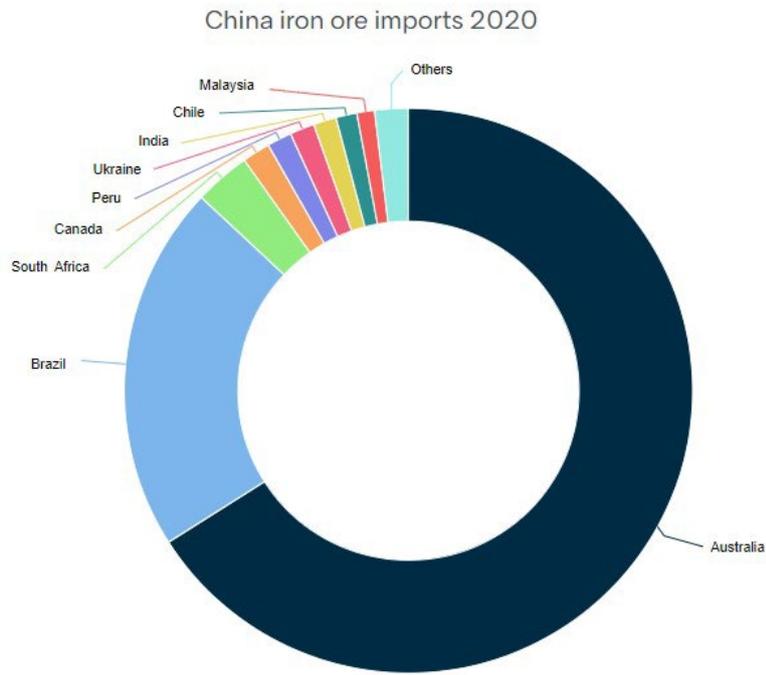
Diversity of supply

1. LIMITED GLOBAL SUPPLY

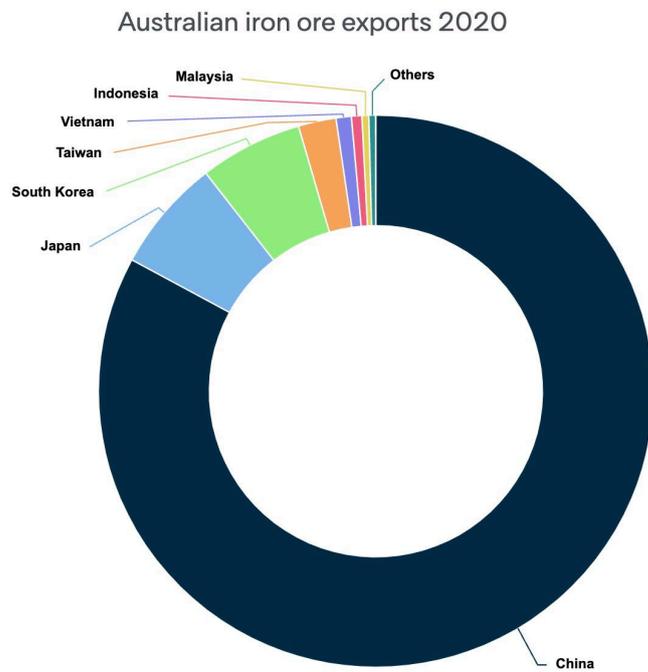
The answer lies in the duopolistic nature of the global seaborne iron ore trade market. In 2020, China imported 1.1 billion tons of iron ore, and 66 per cent came from Australia. Brazil was the second-largest supplier at 21 per cent, and South Africa a distant third with 3.2 per cent of the market.¹²

During the same year, Australia exported 886 million tons of iron ore and China was by far the largest market, making up 82.9 per cent of total exports. Japan and South Korea, the second- and third-largest importers, accounted for 6.6 per cent and 6.0 per cent respectively.

By comparison, Australia's largest competitor, Brazil, shipped 334 million tons of iron ore out of the country and 72 per cent went to China. The key advantage for Australian exporters is geography. It takes on average 18.7 days for Australian bulk carriers to arrive in China and 52.7 days for ships carrying Brazilian ores. This advantage is clearly reflected in onshore price: the average price for Australian ore was \$100 per ton, and \$109 per ton for Brazilian ore. The Australian mining industry also benefits from well-functioning public institutions and an openness to foreign investment, which have helped make it a technological leader in the sector.



Source: Author's calculations from Chinese customs data



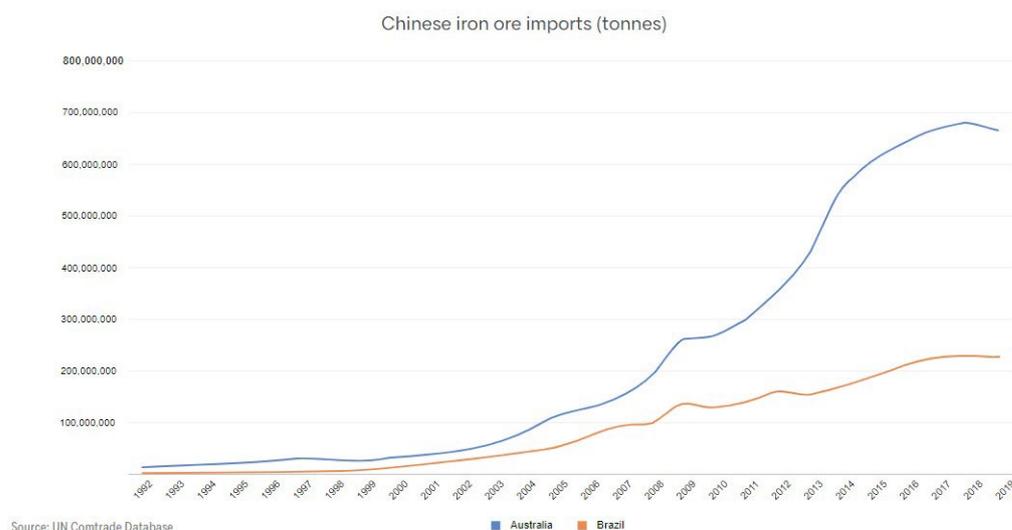
Source: Department of Foreign Affairs and Trade data

CHINESE COERCION, AUSTRALIAN RESILIENCE

China has been helping Brazil build a fleet of ultra-large bulk carriers (“Valemax”), with a capacity of 400,000 tons, to help Vale, the state-owned Brazilian mining giant, reduce its transport disadvantage. Industry sources have suggested that Valemax can reduce transport costs by 25 per cent.

In commissioning ever larger and higher-capacity ships to drive down the cost of transport, China is taking a leaf out of Japan’s playbook from the 1960s and 1970s.¹³ However, there is no reason that such ships could not be used to transport Australian ore, thus diminishing any advantage that might accrue to Brazil.

Australian dominance in the seaborne market and especially for the Chinese market was achieved only in the last decade. Before the financial crisis in 2008, Brazilian iron ore exports to China closely tracked those of Australia. The gap started to widen during the last decade. In 2020, Australian exports to China were three times that of Brazil.¹⁴



The mismanagement of Covid-19 in Brazil and the collapse of tailings dams at Vale, the world’s largest producer, severely impacted Brazil’s production capacity at precisely the moment when Sino–Australian relations were deteriorating. Vale produced 385 million tons of iron ore in 2018. Output declined 21 per cent to 302 million tons a year later.¹⁵ In 2020, the company only managed to produce 300.4 million tons, even less than the disastrous year of 2019.

The company says it is confident of resuming 400 million tons production at the end of 2022, making up lost ground.¹⁶ Once Vale recovers from its capacity constraints, it could add an additional 100 million tons of ore into the market, putting pressure on prices.

For both Australia and Brazil, no market matches the size and significance of China. The single province of Hebei in China, for example, imports more iron ore than the combined volume of Japan and South Korea, Australia's second- and third-largest importers. Altogether, Australia supplies two-thirds of imported raw materials for Chinese steel mills. This produces a highly interdependent relationship between customer and supplier.

The rupture of this relationship could spell disaster for both countries. One of Australia's most prominent mining executives put it colourfully in 2019, evoking the ability of each side to inflict pain on the other: "China and Australia are in a kind of multi-scrotum clutch on iron ore," he said. "They are not going to hurt us. We are not going to hurt them."¹⁷

China would want to diversify its sources of iron ore away from Australia whatever the political situation.

In the case of China, the steel industry generated 7.2 trillion yuan (approximately \$1.5 trillion) of revenue in 2015, according to the Ministry of Industry and Information Technology. China produces more than one billion tons of steel, making up more than 50 per cent of global production. By comparison, the second-largest steelmaker in the world, India, makes only about 5.9 per cent of the global production. The industry supports four of China's most crucial sectors: housing, infrastructure, industrial machinery, and autos. Collectively, they account for more than 80 per cent of steel consumption in China.

2. BEIJING SIGNALS DIVERSIFICATION

China would want to diversify its sources of iron ore away from Australia whatever the political situation. Political tensions, however, are now accelerating those efforts. Statements by the likes of Senator Matt Canavan of the National Party and Clive Palmer that Australia should tax or restrict iron ore exports only heighten Chinese concerns. Although such statements might seem marginal inside Australia, they have been taken seriously inside China.¹⁸ The big question now is not whether China will diversify supplies, but how. On top of its overdependence on Australia, Beijing has long been unhappy with its inability to influence the global iron ore price, despite the fact it is overwhelmingly the world's largest importer of the commodity.

Over the past decade, the Chinese government has tried a host of strategies to reduce its status as a price taker in the global market. It has tried unsuccessfully to appoint a single negotiator in the China Iron and Steel Association (CISA) to haggle with big miners such as BHP and Rio Tinto. The Japanese steel mills, when

they were the dominant buyer of iron ore, used to negotiate as a single entity, a position that global miners thought put them at a disadvantage.

China has so far failed to replicate this approach, largely due to the highly fragmented nature of the local industry and the way in which competing steelmakers sign supply agreements with miners. The unsuccessful intervention

As a price taker, the Chinese government and steel mills have always looked for ways to boost non-Australian supplies.

from the CISA also resulted in the abandonment of long-term benchmark pricing in favour of a spot price mechanism. With a few large mining companies supplying the market, this has worked to the detriment of Chinese steelmakers.

Beijing has also attempted to set up its own iron ore trading platform in order to gain more influence over pricing. Australian miners have offered perfunctory support to this Chinese initiative, but these efforts have gained little traction. Further, Chinese investors have poured money into Australia and elsewhere to develop additional resources. The most notable example is CITIC's Sino Iron project with Clive Palmer. The project has been widely regarded as a costly misadventure for the Chinese conglomerate.

Despite these efforts and billions sunk into the desert of Western Australia, the seaborne iron ore trade is still dominated by the big three Australian miners — BHP, Rio Tinto, and Fortescue Metals Group — along with Brazil's Vale. In fact, the proportion of the iron ore sourced from mines with Chinese equity has dropped from 50 per cent in the 1980s to less than 10 per cent currently. The goal of the Chinese government is to increase that proportion to 20 per cent by about 2025.

As a price taker, the Chinese government and steel mills have always looked for ways to boost non-Australian supplies and increase Chinese equity in overseas mines as ways to mitigate high prices. The rupture in the bilateral relationship has added urgency to this effort. In a report compiled by the Chinese Academy of Social Sciences, one of the country's leading think tanks, Australia's ranking plunged from the second-safest investment destination in 2019 to the fifteenth-riskiest place within two years.¹⁹

There are now two strands of discussion taking place in China. Senior executives from steel industries and downstream end users are complaining about high commodity prices and their impact on profitability as well as their contribution to inflation. The State Council, China's cabinet, took up this issue in May 2021 as the country was hit with the highest producer prices in more than a decade.²⁰

Chinese Premier Li Keqiang chaired a State Council meeting in May 2021 to address the issue of soaring commodities prices and the inflationary impact on the broader economy. He said the government needed to pay "serious attention to the negative impact of escalating commodities prices" and limit their impact on consumers.

While Chinese miners complain about pricing, political leaders have focused on supply chain security.

At the top of the list at this meeting was iron ore. The government announced an increase in export tariffs for a number of steel products, a cut in import duties to zero for scrap iron, and eliminated export tax rebates in other areas. The government aimed to reduce steel production and thus demand for iron ore. On the supply side, the government proposed to increase domestic supply of iron ore and constrain energy-intensive and inefficient steel mills.²¹

Chen Derong, the chairman of Baowu Steel Group, the world's largest steelmaker, said at the annual CISA conference in January 2020 that the "most painful" issue for the industry was the iron ore price. He made those comments when the price was below \$100 per ton.²² The price later rose to as high as \$234. Chen's frustration over surging prices and China's inability to tame them was shared by other industry bodies. Li Xingchuan of the China Metallurgical Industry Planning and Research Institute says the profit distribution between upstream suppliers, steelmakers, and downstream end users had been completely distorted. "Chinese steelmakers are simply working for international miners," he said.²³

While Chinese miners complain about pricing, political leaders have focused on supply chain security. President Xi himself has made speeches on this topic, largely in the context of tensions with the United States and the need to make sure Chinese business is not dependent on hostile countries for industrial inputs. In April 2020, President Xi delivered what the state media called "an important policy speech" at the Central Economic Work Conference, one of the most critical policy meetings in China. It was later published in *Qiushi* ("Seeking Truth"), a key journal operated by the Chinese Communist Party.

In his speech, President Xi emphasised the security and resilience of China's production and supply chains in the wake of the pandemic.²⁴ Once, Australia would have been irrelevant in such debates. But as a key provider of strategic raw materials for Chinese industry and a close ally of the United States, Australia has taken on heightened importance.

The latest industry plan from 2021 has elevated [China's] resource security to one of the key policy objectives for the next five years.

“In order to ensure the resilience of our industrial economy and national security, we must put more effort into self-reliant, secure, and controllable industrial production and supply chains. There should be at least one alternative supplier for strategic products,” Xi said.²⁵

The president's emphasis on self-reliance and security was amplified at the Central Economic Work Conference. Control over production and supply chains was nominated as the second-most important policy objective after technological self-reliance.²⁶

Seven months after President Xi's speech, the Ministry of Industry and Information Technology issued a draft policy paper on the development of the Chinese steel and iron industry and diversifying supply sources for the steel industry. In the paper, “resource security” was elevated to one of the top six policy objectives, the first time it has been ranked so highly as a concern. The issue is now ranked alongside other long-standing industry priorities such as industrial consolidation, innovation, and reducing pollution.

In the previous policy document published five years earlier, the main issues identified by the Chinese government were the longstanding problems of excess capacity, lack of innovation, environmental protection, and “the disorderly” steel market. Resource security only warranted a one paragraph mention towards the end of the industry plan, with a focus on pricing mechanisms and overseas investment.

However, the latest industry plan from 2021 has elevated resource security to one of the key policy objectives for the next five years. The language is stronger, and the discussion of the issue has moved from the end of the policy paper to the forefront, signalling a significant shift in Beijing's official thinking.

The 2021 draft policy document contained considerable detail about diversifying supplies, including targets for domestic production of iron ore, the recycling of scrap metal, and sourcing more resources from Chinese-invested mines overseas. The document also emphasised the need to strengthen relations with

“friendly” neighbours such as Russia, Myanmar, Kazakhstan, and Mongolia, and promote exploration and extraction in Southeast Asia, Central Asia, and Africa.

This paper was the strongest policy statement from the Chinese industry planner and regulator underlining its intention to cut its dependency on Australian iron ore. It also signalled support for the development of the much-anticipated Simandou project in Guinea, West Africa.

The document “encourages steelmaking, transport, energy, and financial services industries to form consortia to accelerate the development and construction of large-scale iron ore mines in West Africa and Western Australia”. (The Australian reference was likely to the largely finished CITIC Sino Iron project, which is the largest Chinese overseas investment so far in iron ore.)

Beijing’s senior geological technical advisers said the key to resolving China’s supply dilemma was through developing more overseas mines, especially in West Africa.

China’s current minister for Industry and Information Technology, Xiao Yaqing, has been one of the country’s most influential industrial apparatchiks for more than a decade.²⁷ Previously, he served as the chairman of Chinalco (‘China Aluminium’), where in 2008 he pulled off one of China’s largest corporate deals at the time, a US\$14 billion raid to buy nine per cent of the shares in Rio Tinto, the Anglo–Australian miner. Rio Tinto is the largest producer of iron ore in Australia. One of the goals behind the acquisition was to thwart the potential merger of BHP and Rio Tinto.²⁸ China had previously expressed an interest in buying Rio Tinto or another Australian mining major but had been rebuffed.²⁹

The ministry’s elevated concerns over resource security are echoed by China Geological Survey, the key government agency responsible for finding and exploring natural resources. The head of International Resources at China Geological Survey, Xiang Peng, and Hu Peng of Wuhan Bureau wrote in the official newspaper of the Ministry of Natural Resources, *China Mining News*, in August 2020: “Should something happen to Australian and Brazilian supplies, China’s iron ore supplies will be inevitably threatened.”³⁰

Beijing’s senior geological technical advisers said the key to resolving China’s supply dilemma was through developing more overseas mines, especially in West Africa. “From the perspective of resources quality, the percentage of Chinese equity control, and diplomatic relationships, West Africa enjoys many competitive advantages. The timely development of regional iron ore supply bases will be significant in improving China’s iron ore supply security,” they argued.³¹

3. PLAN B: SIMANDOU

The reference to West Africa made by Beijing's senior advisers pertains to the massive Simandou project in Guinea, a country often touted as the potential third global force in iron ore after Australia and Brazil. Industry experts predict Simandou could produce around 150 million tons a year, which could service 14 per cent of China's annual imports of 1.07 billion tons annually.

There are challenges in the Simandou project. The first is the sovereign risk of developing such a large-scale project in a country with weak institutions.

The 110-kilometre Simandou mountain range is regarded as the best iron ore deposit in the world. A senior Rio Tinto executive involved in the Simandou project describes it as a "national crown jewel asset, whether it is in Guinea or Australia or Canada". Apart from Simandou, the executive said there were few high-quality iron ore resources left.³² In the future, iron ore projects are likely to be magnetite projects with low iron content and high processing costs.

In 1997, Rio Tinto was given the exclusive rights to explore and develop one part of Simandou. After changes in ownership of exploration rights, Rio Tinto's share in the project has been whittled down to 44.05 per cent of Blocks 3 and 4 tenements. Chinalco, the Chinese aluminum giant and Rio Tinto's largest shareholder, acquired a 39.95 per cent share in these tenements. The SMB-Winning Consortium comprising a group of Chinese and Singaporean companies beat Fortescue Mining Group to secure exploration rights for Blocks 1 and 2.

There are challenges in the Simandou project. The first is the sovereign risk of developing such a large-scale project in a country with weak institutions. A resource executive involved in the project said, "Because the country is right down at the bottom in terms of poverty, the expectations or demands that come with developing a resource of that magnitude are much higher than they would be elsewhere."³³

The Guinean government, which is trying to extract as much as possible from the project, has insisted on keeping the infrastructure serving the mine entirely within the country. That includes building a 620-kilometre railway, even though a much shorter route was available. The Guinean leaders closed off that option, which would have passed through neighbouring Liberia to the coast, to maximise the financial benefit to their country. Rio Tinto was unwilling to take on such risk to develop the project on Guinean government terms.



The estimated costs of developing Simandou are about US\$15 billion. Guinea's GDP in 2020 was \$US15.64 billion.

Chinese Baowu Steel Group, the world's largest steelmaker, is reportedly organising a consortium including the Chinese sovereign wealth fund and construction and engineering companies to invest in the project.³⁴ Caixin, a leading Chinese media group, reported in June 2020 that Baowu, which produces more than 100 million tons of steel a year, is in discussions with other large steelmakers about financing the project.

Apart from Baowu's consortium, the SMB-Winning consortium has already developed a sizeable mining project in Guinea and transformed the African state into the world's largest exporter of bauxite. Before SMB started their project in Guinea, the country barely exported 300,000 tons of bauxite a year to China. Within 12 months of starting production, Guinea was exporting 40 times that amount. By 2019, annual bauxite exports to China reached a record high of 46 million tons. This alone is evidence that "China Inc", once given a directive by the top leadership, can pull off complex projects in Africa. In other words, Simandou is likely to emerge as a substantial supplier of iron ore to global markets and a competitor to Australia.

Chinese policies on iron ore do, however, contain contradictions. On the one hand, China wants more offshore production to bring prices down and reduce the leverage of Australian miners. On the other hand, Guinea sees Simandou as a nation-building project, not as a means to supply cheap ore to China. Investors, both Chinese and foreign, will also want a return on their substantial investments. Needless to say, efforts to manage and manipulate commodities markets, by national governments, cartels, and private interests, have a long history of failure.

LIQUEFIED NATURAL GAS

For much the same reason as iron ore, the LNG sector has so far been spared from Chinese measures: global supply dynamics mean China still needs Australian LNG. At the same time, China is also about to displace Japan as the world's largest importer of LNG. China's increased demand reflects the size of its economy and its quest for cleaner sources of energy.

Liquefied natural gas is Australia's second-largest export to China after iron ore, worth \$16 billion in 2019. From 2020 onwards, China began importing record volumes of LNG on the back of its initially strong post-Covid economic recovery. Australia's LNG exports to China started in May 2006 when the Chinese government awarded a \$25 billion supply contract to the consortium managed by Woodside Petroleum. The deal, equivalent to almost half of Australia's exports of LNG, would supply gas to six new power stations and converted plants in the Chinese province of Guangdong. The then prime minister John Howard hailed it as "Australia's single largest export deal".³⁵



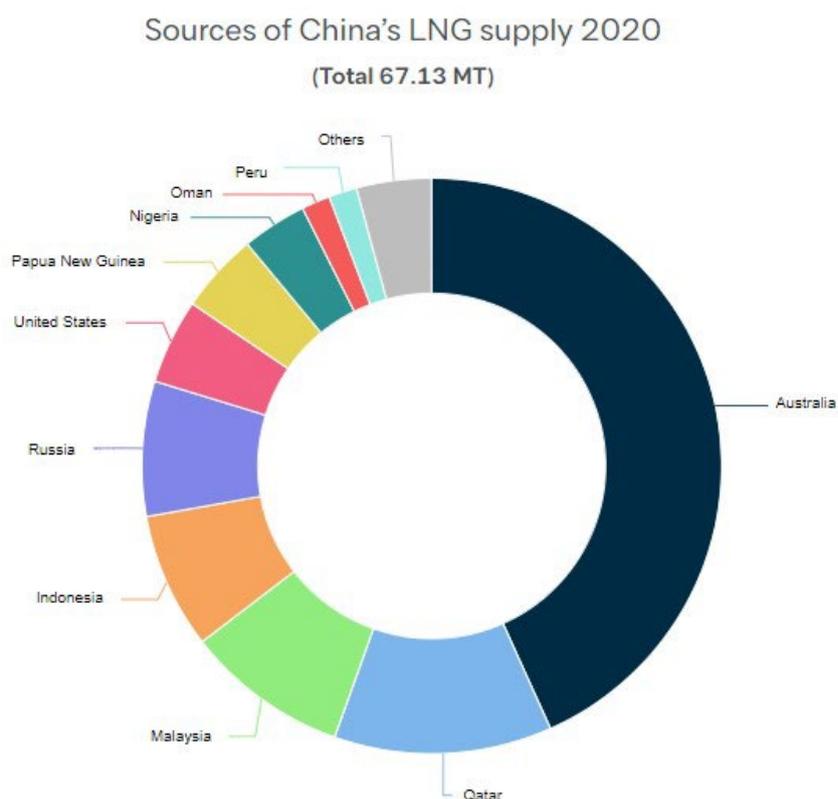
Liquefied natural gas is Australia's second-largest export to China after iron ore. Pictured: LNG tanker, Darwin Harbour, Northern Territory (Geoff Whalan/Flickr)

The Chinese premier at the time, Zhu Rongji, reportedly went against the recommendation of Beijing's economic planning agency and supported the Australian proposal. Prime Minister Howard's pitch to Zhu on Australia's record

as a longtime, reliable supplier to Japan and then South Korea played a key role in closing the deal.³⁶

Since the original 2006 contract, Australia has been the main supplier of LNG to the Chinese market. Between 2017 and 2020, Australia accounted for 43 to 45 per cent of China’s total imports of LNG.

Large-scale LNG projects have high upfront development costs and lengthy return periods measured in decades. These investments are made possible by long-term off-take agreements like the one signed with China in 2006. Australia is currently benefiting from investment and exploration decisions made at the early part of the last decade. In the past decade, an estimated \$305 billion has been invested in Australian LNG projects.³⁷



Source: China Customs Data

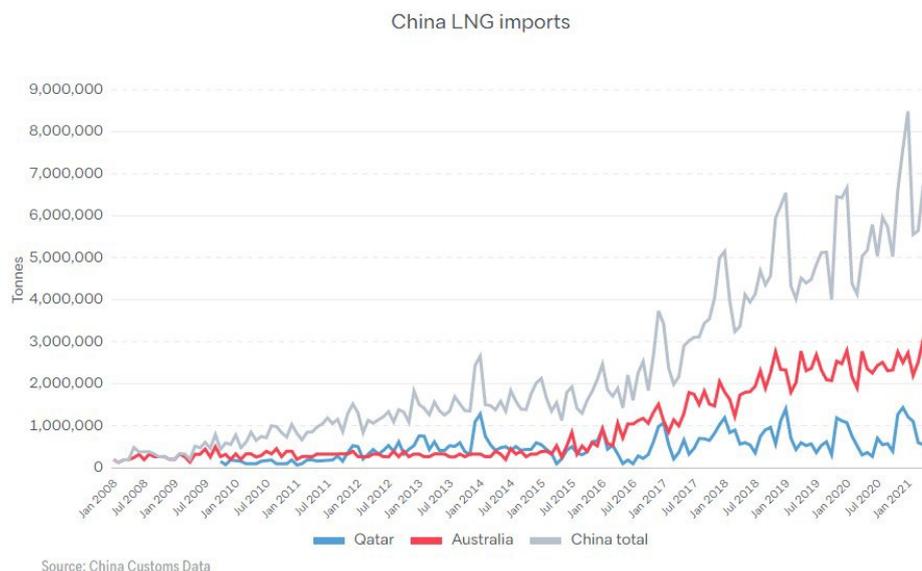
As with iron ore, Australia is geographically and geologically blessed to benefit from the growth of the East Asian LNG market. The global centre for LNG demand comes from the nearby industrial powerhouses of Japan, China, and South Korea. They account for 21.7 per cent, 17.4 per cent, and 11.3 per cent respectively of global demand. China overtook Japan to become the largest buyer of LNG in 2021.³⁸

CHINESE COERCION, AUSTRALIAN RESILIENCE

Due to limited supplies and strong demand, the spot price for LNG has recently been at historic highs. As a result, Australian suppliers do not have immediate pressing concerns about being hit because of strained ties with Beijing.

Still, China has access to a broader range of suppliers than in the much tighter market of iron ore. China currently imports natural gas via two major channels: 37.6 per cent comes from pipeline gas sourced from countries such as Russia and Turkmenistan, and 62.4 per cent comes from seaborne LNG.³⁹ In total, China sources supply of LNG from more than 20 countries.

After Australia, which holds just over 40 per cent of the import market, the largest suppliers of LNG to China are Qatar (12 per cent) and Malaysia (nine per cent). Other major producers are courting China as the global growth market. Qatar, the world's largest LNG producer at the moment, is pressing Chinese oil majors to join its US\$28.7 billion North Field Expansion project, the world's largest single LNG project. One industry insider describes Qatar's marketing efforts in Beijing as "aggressive and all-embracing".⁴⁰



Qatar has supplied China with 62 million tons of LNG since 2009.⁴¹ In some cases, they have offered this at discounted prices. In March 2021, Qatar Petroleum also signed a ten-year LNG contract with Sinopec, a major Chinese oil and gas company, for the supply of two million tons a year of LNG for China. Shipments will begin in 2022 — representing an immediate increase in volume to China of more than 25 per cent.⁴²

Qatar is a key part of China's broader strategy of diversification from Australia. "Currently, we may not consider signing long-term contracts for Australia-origin

or US-origin LNG cargoes in order to avoid the risks of geopolitics and high supply proportion from a single country,” a trade source from one of China’s national oil companies told Platts S&P.⁴³ The rating agency says there is significant room for Qatar’s share of China’s gas supply to grow.

A Chinese energy industry source said, “The national oil companies have to be seen to do something about diversification. They will not increase Australian intake and avoid dealing with Australian suppliers openly.”⁴⁴ In late 2021, *Global Times*, the nationalistic newspaper under the direct control of the ruling Communist Party, trumpeted talks between Chinese importers and US LNG suppliers. The article explicitly stated that the Chinese were courting US suppliers to send a message to Australia. In part, buying from the United States was designed to alleviate trade tensions between the two countries. Still, at a time when Washington and Beijing are locked in a bitter competition on multiple fronts, China’s outreach to the United States for energy underlined their desire to punish Australia.⁴⁵

China retains substantial Australian interests. Large Chinese state-owned giants have invested considerable amounts of money in the Australian LNG sector.

Researchers from the Chinese Academy of Social Sciences are also recommending China reduce its dependency on Australia. “In recent years, the proportion of Australia-sourced LNG is approaching 50 per cent of total imports. China needs to diversify import sources and increase the efficacy of its pipelines to Myanmar, Central Asia, and Russia and reduce dependency on a single country.”⁴⁶ The researchers said that both iron ore and LNG were “strategic raw materials” that necessitated taking into account risks in the relationship with Australia.

These projects form part of China’s vast transnational gas and oil pipeline network that connects the country with so-called “friendly” oil and gas producers such as Myanmar, Turkmenistan, Kazakhstan, and the energy powerhouse of Russia.⁴⁷

The most significant of those projects is the supply agreement and pipeline connection between Russia and China. In 2014, Russia and China signed a 30-year gas supply deal worth US\$400 billion. This deal proved to be mutually convenient for both countries: a Russia that had been isolated diplomatically after its annexation of Crimea (and later its invasion of Ukraine) could sell into a country that is both a massive growth market and a strategic partner in need of a long-term secure supply.⁴⁸

CHINESE COERCION, AUSTRALIAN RESILIENCE

One Chinese energy analyst commented that a factor working against the Russian pipelines was distance. It still makes more commercial sense for major coastal users of natural gas to import LNG from countries such as Australia.⁴⁹ The two biggest users of gas are the two prosperous coastal provinces of Jiangsu and Guangdong, which have the highest GDP per capita in China.⁵⁰

Apart from diversifying its sources of supply, China has also invested a record amount in exploring and producing gas at home. Chinese geologists have reportedly discovered major gas fields in the Sichuan, Tarim, and Erdos Basins.⁵¹

Yet while seeking to diversify, China retains substantial Australian interests. Large Chinese state-owned giants have invested considerable amounts of money in the Australian LNG sector. For example, CNOOC, one of China's three major state-owned oil and gas giants, has taken stakes in two of Australia's largest LNG development projects: the \$34 billion North West Shelf project and the \$20.4 billion Queensland Curtis LNG project.⁵² Sinopec invested in the \$24.7 billion Australian Pacific LNG project. A senior Chinese executive from the sector commented, "We have put a lot of money into Australian assets. We won't walk away from these long-term agreements."⁵³

COAL

Australia's third-largest export sector, coal, has been subject to an unofficial ban from China since the second half of 2020, although there were signs of it easing by mid-2022. The Chinese have been ruthless in enforcing the ban. Coal-carrying ships languished for months in Chinese waters without permission to unload, despite the strain on crews. There was a complete halt in thermal coal exports to China from the Port of Newcastle, the world's largest coal export terminal, among others.⁵⁴

Yet the impact of the unofficial ban on the coal sector has been relatively modest, according to trade data. Australia exports two types of coal: thermal coal, which is used for power generation; and coking coal, which is used for steelmaking. The ban's impact has been far greater on thermal than it has been on coking coal.



Australian coal has been subject to an unofficial ban from China since the second half of 2020. Pictured: Premier coal mine, Collie, Western Australia (Calistemon/Wikimedia)

Even China's import restrictions on Australian thermal coal have led to only a modest decline from 213 million tons in 2019–20 to 194 million tons in 2020–21. Australia's Department of Industry, Science, Energy and Resources is forecasting a recovery to 212 million tons by 2022–23.⁵⁵

The impact on coking coal sales to China is much less. The exports are forecast to increase from a 2020–21 low of 171 million tons to 186 million tons in the next financial year. The department says the supply chain disruption caused by China’s ban has been largely overcome.⁵⁶

The biggest threat to the Australian coal industry is not China’s unofficial ban but local Australian banks pulling out of the sector due to the global push to cut carbon emissions.

However, a senior executive from Australia’s largest miner, BHP, is less sanguine than the government about the success of Canberra’s diversification strategy.⁵⁷ “The price of our Australian coal — [metallurgical coal] — is basically half. So, that is a big challenge. It is not a situation that is sustainable,” said Edgar Basto, president of BHP Minerals Australia. “I have heard comments [that] the coal being produced in Australia and in Queensland is being placed in different markets so there is no harm there. I don’t think that is right because the

differential in price is almost half what we are getting for our coal than what others are getting in China.”

There have been numerous reports of the impact of the Australian ban on the Chinese economy, with some suggesting Beijing has struggled to keep the lights on in some parts of the country as a result. However, industry executives and analysts say the importance of Australian thermal coal exports to China is exaggerated. In fact, the exports represent only a fraction of consumption. China produces about 3.85 billion tons of coal a year, and total coal imports are about 300 million tons, with Australian coal only a small part of that. Australian thermal coal is a swing factor, at best.

The biggest threat to the Australian coal industry is not China’s unofficial ban but local Australian banks pulling out of the sector due to the global push to cut carbon emissions. All four big Australian banks have announced their timed withdrawal from both coal-fired power plants and mines.⁵⁸

Australian coal companies have made this point strongly in their submissions to the Joint Standing Committee on Trade and Investment Growth. Centennial, a NSW-based coal miner, claims it is finding it difficult to raise finance and obtain insurance from Australian banks and insurers. It is only able to obtain funds from Asian banks, which provide 98 per cent of its debt facility.

Centennial argues even this Asian credit facility is under threat, with non-Australian banks highly unlikely to participate if local Australian banks are not involved in the syndicates.⁵⁹ Whitehaven Coal similarly argues that because

international lenders rely on the credit expertise of Australian banks, their withdrawal from the market would deal a savage blow to the sector.⁶⁰ Ironically, Chinese banks have become a major source of funding for Australian coal miners in the place of local banks. For example, Chinese banks currently account for 40 per cent of Whitehaven Coal's syndicated facility, for which Bank of China is the biggest lender.⁶¹

A senior bank executive with responsibility for the coal industry says, "Chinese banks in Australia are providing 70 per cent of new credit to the coal industry. The big risk for the industry is the Chinese banks may pull out of funding the sector in the foreseeable future due to carbon neutral policy in China."⁶²

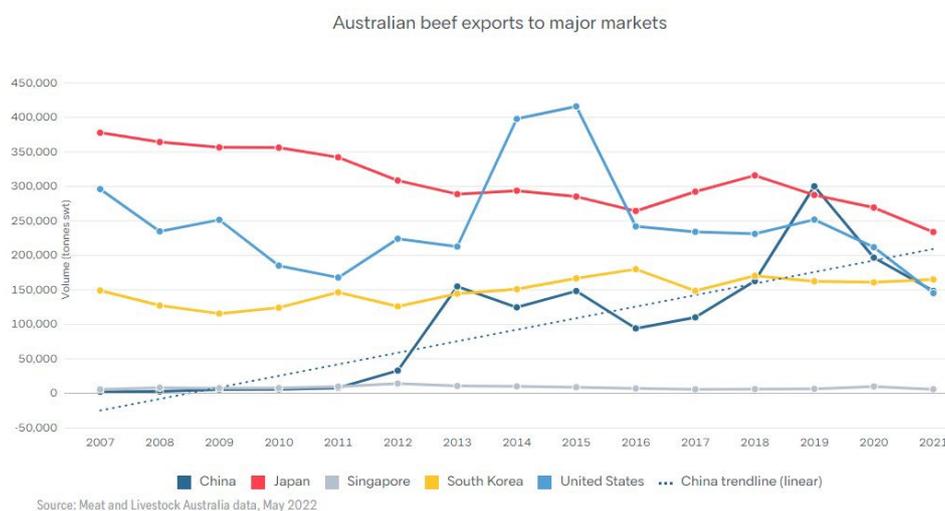
If the Chinese banks were to scale back their lending in Australia, it would be a far bigger problem for the industry than the unofficial ban, which is a more manageable problem. Of all the problems the coal industry is facing at the moment — from climate change risk to difficulty in obtaining credit — the geopolitical spat with China may be the least of them.⁶³

BEEF

In 2019, China was the single most important beef export market for Australia. China imported 300,133 tons of beef from Australia, accounting for a quarter of all overseas sales.⁶⁴ It was the first year in which China assumed the status as the largest export market, and a signal of the huge potential growth to come.

However, export volumes to China dropped by as much as one-third in 2020 from the 2019 peak after Beijing introduced partial bans on a number of abattoirs. The bans carried the whiff of political targeting — one was in the electorate of the former minister for Agriculture, David Littleproud.⁶⁵ From January to July in 2021, the exports declined year-on-year by 37 per cent.⁶⁶

As the graph below demonstrates, China only emerged as a significant Australian beef export market in the last decade. Japan, the United States, and South Korea dominated Australian beef exports between 2007 and 2021. These three markets accounted for more than 67 per cent of all beef exports. During the same period, China accounted for just under 10 per cent of all exports.⁶⁷ Even in 2019, when China overtook Japan as the largest importer of Australian beef, Japan, South Korea, and the United States still accounted for 57 per cent of exports.⁶⁸



China emerged as a key importer from 2013, replacing South Korea as the third-most important market. It received a further boost in 2017 after the visit of Chinese Premier Li Keqiang, who signed a major deal with then prime minister Malcom Turnbull. Volumes to China almost doubled between 2018 and 2019.

But the impact of Chinese restrictions is not confined to export volumes alone. It is about the lost premium and other hidden costs not easily captured by trade data, such as significant erosion of the commercial value of abattoirs, some of which lost their China licences and their standing as a brand in that country. As such, the restrictions have hit both volumes of beef going into China as well as the premiums the market offered. “You can diversify away from volume, but you can’t diversify away from premium,” said Patrick Hutchinson, CEO of the Australian Meat Industry Council.⁶⁹

He estimates that Australian exporters get between \$150 and \$300 more per head of animal from the Chinese market than anywhere else because they pay above the odds for all animal parts. And when you lose your China licence, you also lose a lot of the commercial value of the abattoirs that hold them. “Japan is a solid market. The US ebbs and flows. The UK and the EU are quota markets. If we lose China, it is unlikely that we will find a comparable market,” said Hutchinson.

But the impact of Chinese restrictions is not confined to export volumes alone. It is about the lost premium and other hidden costs not easily captured by trade data

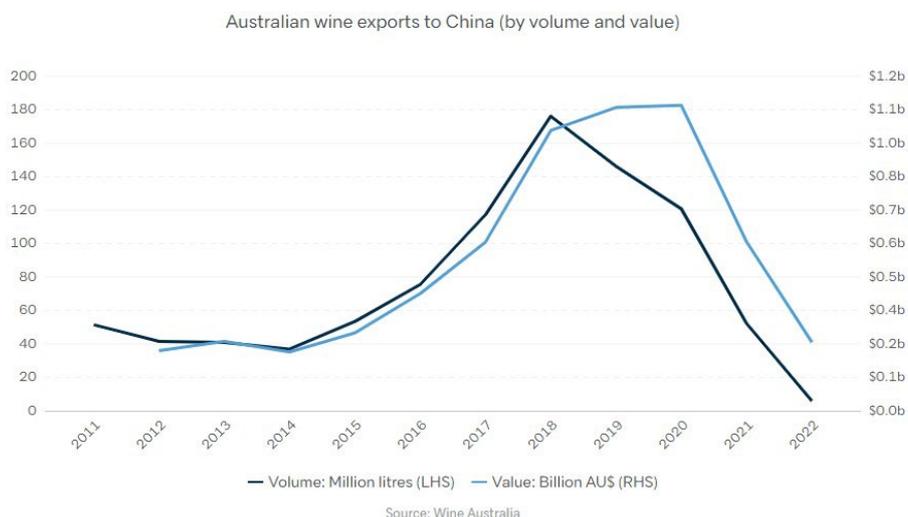
An industry expert from Meat and Livestock Australia, which represents cattle and sheep farmers, echoes Hutchinson’s assessment, saying China pays substantially more for many products such as beef briskets, which enjoy a premium of up to 70 to 80 per cent. “Tell business to diversify? It is just naïve. We can’t just give up premium.”

The industry executive also mentioned that apart from China’s strict requirements on labelling, with violations in labelling used to justify de facto trade barriers, one of the big challenges for Australian exporters has been the US–China Phase One trade deal. The United States extracted a major concession from China, which gave the US regulators the responsibility for policing the licensing and labelling of meat processing export plants. That removes one of the major trade weapons from the arsenal Beijing has used against Australia. Summing up, the executive said the Chinese measures had been damaging, but not a deathblow. “China was not a market ten years ago; it takes the cream off the top.”⁷⁰

WINE

The wine industry is one of the sectors hardest hit by China’s trade measures. Beijing’s punitive tariffs introduced in November 2020 and a bumper harvest year in 2021 created a perfect storm, especially for medium- and small-sized players. Tariffs as high as 218 per cent were imposed on allegations that Australia was “dumping” its wine or selling at below market value and thereby damaging local Chinese producers. Australia has challenged China’s dumping finding in the World Trade Organization.

Between September 2020 and September 2021, the value of Australian wine exports globally declined by 24 per cent to \$2.27 billion and volumes fell by 17 per cent to 638 million litres. Exports to China dropped 77 per cent over the same period, which was the key driver behind the significant fall overall. As with beef, China had previously bought not just large volumes of Australian wine but also offered a substantial premium. China represented 12 per cent of export volumes but 38 per cent of premium.⁷¹ In the words of one prominent winemaker, “We have lost our biggest margin customer and finding another one will be challenging. Grape prices will fall, and many growing contracts will not be renewed.”⁷²



On diversification, the industry expert, who has decades of experience in South Australian winemaking, says it is easier for large players such as Treasury Wine Estates to adjust as they can make international brands elsewhere. “Smaller players can’t adjust fast enough, and it will have a lasting impact on growth and profitability.”

Treasury Wine Estates, the owner of the famous Penfolds brand, is an example of the disparity between exporters' ability to adjust. Under the former CEO Michael Clarke, Penfolds was elevated to a luxury brand in China with significant benefits for the company.⁷³ According to a Treasury presentation to analysts, the Chinese market was by far the largest profit centre, overshadowing other regional markets such as the Americas, New Zealand, and the rest of Asia.⁷⁴



The Australian wine industry is one of the sectors hardest hit by China's trade measures. Pictured: Barossa Valley (Thomas Shaefer/Unsplash)

In November and December of 2020, the company's wines were hit with a combined duty of 176.5 per cent.⁷⁵ The interim results released in February 2021 confirmed the impact of the Chinese measures. Net profit was down 24 per cent and revenue was down eight per cent.⁷⁶ *Fortune* magazine reported the results with the alarming headline, "Chinese tariffs are crushing the world's largest listed winemaker."⁷⁷ Six months later, when Treasury Wine Estates published its financial results for the full year, the P&L looked better, with revenue and earnings before interest and tax stabilising. Profits were slightly up. The company's diversification strategy was paying dividends.

In May 2022, the company announced that it planned to produce a Penfolds-branded wine in China using local grapes in a further effort to maintain the value of the brand. Treasury Wine Estates CEO Tim Ford commented that the company is not basing its business strategy on the tariffs being lifted. He said he spent "zero per cent of my time wishing for the day" when that might happen.⁷⁸

CHINESE COERCION, AUSTRALIAN RESILIENCE

In comparison to the larger companies, a smaller Adelaide-based wine exporter saw its business destroyed by the tariff. A wine exporter who does not want to be named said he was doing \$30 million a year in business with China and exported about seven million bottles annually. “I was doing 400 to 500 containers a year and now I am down to one container a year,” he said. “I have no hope whatsoever for the China market and it will not recover in my professional life. It has taken me many years to build the market and distribution channels. No one wants to touch Australian wines right now. It’s simply too risky.”⁷⁹

BARLEY

Tsingtao, China's most famous brewer, has been using Australian barley for years to make its premium quality beer.⁸⁰ This long relationship ended abruptly when the Ministry of Commerce imposed an 80.5 per cent tariff on Australian barley, made up of a 73.6 per cent anti-dumping duty and 6.9 per cent countervailing duty in May 2020.⁸¹

The tariffs were introduced after an 18-month anti-dumping investigation initiated by the ministry. In part, the barley dumping duties were in retaliation for the scores of anti-dumping actions taken by Australia against Chinese products.⁸² Beijing claims the plethora of Australian anti-dumping actions runs against the spirit of the 2015 bilateral trade agreement. In June 2021, China filed cases with the World Trade Organization in Geneva against Australian anti-dumping measures on Chinese goods, challenging duties on train wheels, wind turbines, and stainless-steel sinks. The Chinese suit came a week after Australia filed its own case on wine.⁸³ However, the barley tariffs, and the timing of their imposition, only made sense as a part of China's broader economic coercion strategy against Australia in the context of deteriorating bilateral relations.



Tsingtao has been using Australian barley for years to make its premium quality beer. Pictured: barley field, Yorke Peninsula, South Australia (Dualiti Photos/Flickr)

CHINESE COERCION, AUSTRALIAN RESILIENCE

Imported barley, especially from Australia, has long been a key ingredient for Chinese brewers. Chinese domestic barley production only accounts for 15 per cent of local consumption and is of inferior quality. Chinese brewers lobbied against the tariffs on Australian barley but failed.

Between 2014 and 2019, Australian barley exports to China averaged about \$1.2 billion a year. In 2017, Australian barley accounted for 70.6 per cent of China's total imports. The high tariffs mean Australian barley is no longer competitive in the Chinese market.

The Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) estimated in June 2020 that around 40 per cent of the barley exports originally intended for China would find alternative markets in the medium term. The agency also estimated the cost of the lost price premium and developing alternative markets would be around \$330 million. As it turned out, barley exports increased by 105 per cent year-on-year between May 2020 and May 2021, but that was a result of an exceptional harvest. Australia's 2020–21 barley crop exceeded 13 million tons, the second-highest in history.⁸⁴

At the same time, the average value of barley exports dropped from \$407 per ton in 2019–20 to \$310 per ton in 2020–21. This is largely due to the fact that Australian barley has been sold as lower-value animal feed into new markets such as Saudi Arabia, Thailand, and Vietnam instead of high-value malting barley for China's breweries.⁸⁵



Source: Department of Agriculture, water and the environment

A major grain and barley exporter from Western Australia said diversification from China had been challenging. “If we have to diversify from China, our business needs to shrink significantly. Our margins are small, so we are on a knife edge. Other markets are not paying the same price.”⁸⁶ A barley grower in Western Australia said, “We are selling into alternative markets, but we don’t have the premium that the Chinese were paying. That’s the real crux of the matter. The Chinese were prepared to pay a premium for feed barley that would normally go into animal consumption markets.”⁸⁷

A former senior National Farmers’ Federation executive said other exporters had replaced the Australian barley in the Chinese market. “What we have been doing in Australia is selling our grains to those markets that the US used to sell to. So, there is a round robin going on. There has certainly been a reduction in price caused by that round robin because the Chinese were paying a premium over feed prices. Barley, generally malting barley, usually sells for the same price as wheat. Feed barley sells at a significant discount, usually about 20 per cent.”⁸⁸ Notably, barley imports from Argentina, Canada, France, Kazakhstan, and Ukraine have risen significantly in China since the imposition of duties on Australian barley imports.

WOOL

Wool was the second-most valuable Australian agricultural export to China after beef in 2019, valued at US\$1.7 billion. In recent years, China accounted for about 80 per cent of Australia's raw wool export and the proportion increased to more than 90 per cent during the acute pandemic period, making China indispensable for the country's 50 000 wool producers.⁸⁹

China's market share of Australian wool exports increased from 4.2 per cent in 1990 to more than 90 per cent in 2021. China is the largest buyer of Australian wool in terms of volume, and the largest importer of high-value Australian fine and superfine wool. China's appetite is easily explained — it is the world's largest textile exporter as well as the largest consumer market for wool. In recent years, China's growing middle class has been increasingly drawn to high-end fashion and sportswear made from Australian wool.⁹⁰



Wool was the second-most valuable Australian agricultural export to China in 2019. Pictured: sheep loaded onto trucks from sale yards, Ballart, Victoria (Jo-Anne McArthur/Unsplash)

Despite current tensions, the chances that Australian wool could become the next target for China are low. In 2019, 75 per cent of China's greasy wool imports came from Australia. The next two biggest import source countries were New Zealand (7.5 per cent) and South Africa (7.2 per cent). A major Chinese wool importer said there were no alternatives to Australian wool at the volumes the company needed to buy. In addition, he said the industry enjoyed a decades-long relationship with Australian suppliers, with strong commercial and personal ties.⁹¹

High-quality wool is also a key ingredient for Chinese suppliers who make high-end fabrics for European fashion houses and other consumer products. In 2019, China exported US\$3.65 billion worth of finished wool products. Unlike other agricultural commodities hit by China such as wine, lobster, and barley, Australian wool imports are not only consumed in China but destined for international markets. Like the Chinese steel industry and Pilbara resources producers, China's textile industry and Australian farmers have also come to rely on each other. Asked about finding other markets, one Australian executive said the wool industry could spend all of its marketing budget on countries outside of China and it "would not have moved the dial".⁹²

Another salient factor is Australia's limited capacity to process wool at home. It is estimated that the country has the capacity to process less than five per cent of all home-grown wool. "The wool manufacturing industry left this country a long time ago, it is not coming back," the executive said.

Though it is unlikely that Beijing would target Australian wool in light of the lack of ready alternatives, local industry players have looked at previous shocks to the industry to gauge the possible impact. The wool industry suffered two major shocks in the first half of the 1990s: the collapse of the Soviet Union as a major customer; and the abolition of the Australian government's Wool Reserve Price Scheme.

In the 1980s, the Soviet Union was the largest customer for Australian wool, buying nearly 40 per cent of exports. When the Soviet empire collapsed, Russian purchases of Australian wool fell with it. The price of Australian wool also dropped by nearly 20 per cent. Though the Soviets were the most important buyer of Australian wool, their dominance was not close to the current level of Chinese purchases.

A Chinese boycott of Australian wool, as unlikely as it is, would have the equivalent impact of the Australian government's momentous decision to abandon the Wool Reserve Price Scheme in 1991. When the government announced the suspension and then abolition of the scheme, wool prices dropped from 700 cents per kilogram to 450 cents per kilogram almost overnight.⁹³

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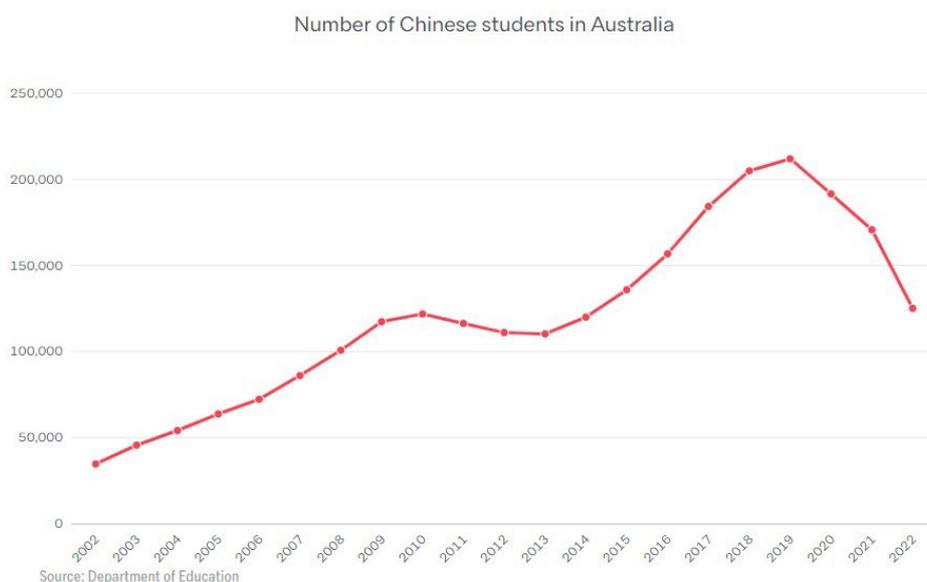
CHINESE COERCION, AUSTRALIAN RESILIENCE

Andrew Martin, a former chairman of the Sheep and Wool Council of Queensland, can still recall the devastation. “There was a lot of personal angst and horror. The market for sheep was dead. I can’t remember how many sheep were destroyed as a result. It was just terrible.”⁹⁴ One senior industry executive said the size and importance of the Chinese market was comparable to the role of the Australian government-sponsored commodity price stabilisation scheme. A Chinese boycott today could cause a similar level of devastation to Australian sheep farmers.⁹⁵

EDUCATION

International education is the most valuable services export sector for Australia. Although there have been warnings from the Chinese government about student safety in Australia, there has been no official or semi-official boycott of Australia's higher education system so far. However, the sector has been hard hit by China's Covid-zero policies, which have curtailed the number of Chinese students able or willing to travel abroad for their studies.

One of the key forces behind the success of Australia's higher education sector in the years prior to the Covid pandemic had been consistent and rising demand from China. The People's Republic of China has been the most important education export market for Australia since 2002.⁹⁶ The number of full-time students increased from 34 653 in 2002 to an all-time high of 211 915 in 2019.⁹⁷



Although the absolute number of Chinese students has declined significantly from this 2019 high, dropping by more than 40 per cent to 121 033 in 2022, China remains Australia's largest single source of international students. Projected demand for the 2023 academic year is strong. The resilience of Chinese enrolments is even more impressive considering the restrictive border policies of Australia and China for much of 2020 and 2021. Beijing has maintained a tight outbound travel policy into 2022.

Of the top three source countries for international students, only the Chinese have demonstrated strong willingness to study online from outside Australia. Department of Education data show 37 per cent of Chinese students are enrolled

CHINESE COERCION, AUSTRALIAN RESILIENCE

offshore, compared to 8 per cent of Indian students and 3 per cent of Nepalese, the second- and third-largest source countries respectively.⁹⁸ Beijing's willingness to recognise online degrees reflects the value the country sets on education and the investment in it by Chinese families.

Top 10 visa holders by citizenship

Citizenship country	In Australia	Outside Australia	Total	% outside Australia
China	76,178	38,338	114,516	33%
India	58,205	5,066	63,271	8%
Nepal	40,012	817	40,829	2%
Vietnam	15,828	1,768	17,596	10%
Indonesia	11,066	1,539	12,605	12%
Thailand	12,224	2,605	14,829	18%
Colombia	12,267	4,335	16,602	26%
Brazil	10,988	2,119	13,107	16%
Malaysia	10,667	977	11,644	8%
Philippines	10,231	1,712	11,943	14%
Other	106,094	17,629	123,723	14%
Total	363,760	76,905	440,665	17%

Source: Department of Education, Student Visa Holders in and outside Australia, 12 September 2022

Universities Australia Chief Executive Catriona Jackson says, "Students from China, for example, have shown a greater willingness to enrol and study online at an Australian university. Others, especially from India and Nepal, have sought to study in northern hemisphere locations that have kept relatively open borders."⁹⁹

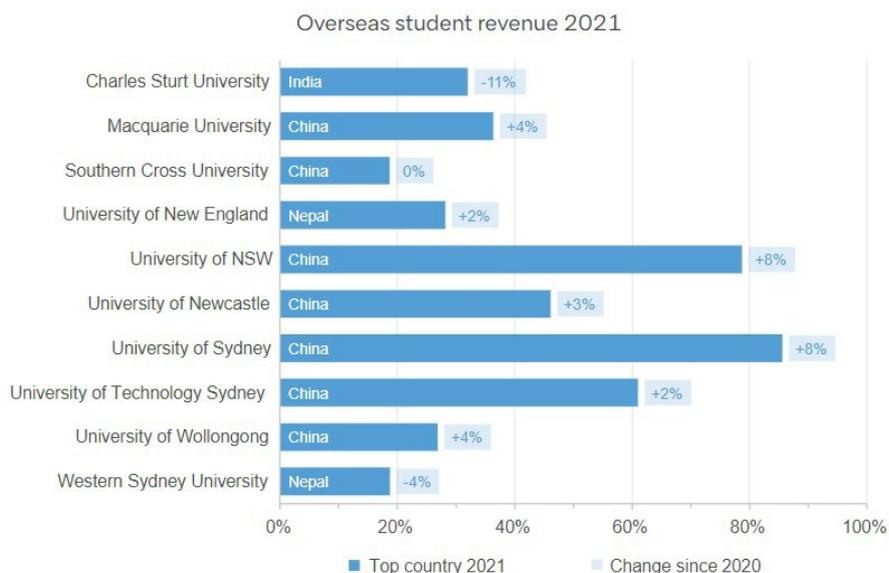
In light of current tensions, how vulnerable are Australian universities to a sharp decline in Chinese students? Though the sector is reliant on overseas enrolments, and especially the Chinese, for revenue, the level of exposure varies across the sector.

The Group of Eight (Go8), the self-styled elite Australian universities that undertake 70 per cent of the country's university research, is the most reliant on Chinese students. According to one estimate, more than 70 per cent of Chinese students are enrolled at Go8 universities, making those institutions uniquely exposed to any potential decline in Chinese enrolments.¹⁰⁰ Though universities do not break down their student enrolment numbers by nationality, the New

South Wales Auditor-General’s report into the higher education sector provided details on the risk spread among universities.

In 2021, the higher education system in New South Wales received \$12 billion in revenue. The largest revenue stream was \$5.8 billion from student fees and charges. Overseas students contributed \$3.1 billion to universities, making them a revenue source comparable to government grants.¹⁰¹

Between 2017 and 2021, Chinese students accounted for 45 per cent of international enrolments in New South Wales, making them the single largest group by far. Seven out of ten New South Wales universities count China as the single largest source country for overseas students. Two members of the Go8 — University of Sydney and University of New South Wales (UNSW) — have the highest proportion of Chinese students, about 80 per cent in each case. In 2021, every second international student enrolled in New South Wales was from China.¹⁰²



Source: Audit Office of New South Wales

In April 2020, the University of Sydney forecast a 17 per cent drop in overseas students and a \$470 million loss.¹⁰³ However, by 2021, the university reported \$1 billion in net profit. It is no coincidence that the University of Sydney has the highest proportion of Chinese international students enrolled in New South Wales. They underestimated their profits because they had underestimated the willingness of Chinese students to take their degrees online.¹⁰⁴

CHINESE COERCION, AUSTRALIAN RESILIENCE

The University of Queensland enrolled a record number of 17 956 international students in 2021, of which Chinese students numbered 11 265 — up from 7,466 in 2020 and 8,995 in 2019.¹⁰⁵ By contrast, the non-Go8 universities did not fare as well. The University of Technology Sydney (UTS) and Macquarie University suffered losses of \$50.6 million and \$51.4 million respectively.¹⁰⁶

One senior university administrator said overdependence on Chinese students was really a Go8 problem, or more precisely, a Go5 problem (University of Sydney, UNSW, University of Melbourne, Monash University, and University of Queensland). Chinese students flock to those institutions because of their reputation and global rankings.¹⁰⁷



International education is the most valuable services export sector for Australia. Pictured: University of Sydney, Camperdown campus (Andy Wang/Unsplash)

Throughout the pandemic, and despite official travel warnings for Australia, Chinese students have remained committed to their courses in Australia. In fact, many universities have deepened their dependency on China, and in the short term, that has been profitable.

A senior executive from one of the largest international education companies in China said he had not seen any sign of measures against Australian education. Rather, the Chinese government has encouraged students who stayed in China during the pandemic to continue coursework online and reassured them their degrees would be recognised as equally valid as those obtained on campus.

“Most Chinese students who choose to study in Australia are self-funded. They and their parents will choose which institution to attend based on their preferences and their eligibility for admission,” he said.¹⁰⁸ The vast majority of Chinese studying in Australia have been recruited by educational agents.

A Deputy Vice-Chancellor from one of the G8 universities said, “Chinese students’ enrolment at the university didn’t decrease significantly despite the fact that about two-thirds were unable or unwilling to return to Australia. They are all continuing their education online.” He said the impact on each university in Australia would differ and each would have to employ their own strategies to adapt. On an optimistic note, he said there were more than ten million Chinese high school graduates every year and 60 per cent of them want to go to university, including studying overseas.

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He emphasised that Australia has invested heavily in improving education quality and accommodating large numbers of overseas students. It has taken years for Australian universities to earn a reputation for offering high-quality education. On that basis, Australia should be able to stay competitive in global education, including in China.¹⁰⁹

Though Chinese student enrolments remain resilient relative to other source countries such as India, Australia’s leading competitors, including the United Kingdom and Canada, have seen only a small decline in Chinese student numbers due to more relaxed border policies. For example, the number of first-year Chinese students enrolled at British universities declined only modestly from an all-time high of 104 240 in 2019–20 to 99 160 in 2020–21. During the same period, Australian enrolments dropped by more than 40 per cent.¹¹⁰

TOURISM

Prior to the pandemic, China was Australia's largest inbound tourist market for both arrivals and spending. There were more than 1.4 million visitors from China in 2019, contributing a combined total of some \$12 billion to the Australian economy¹¹¹. Those numbers have been reduced to a dribble in the last two years due to Australia and China's pandemic border policies. While Australia's international border has since re-opened to foreign travellers, Beijing is keeping its international aviation capacity at just a fraction of pre-pandemic levels and is advising Chinese nationals not to travel overseas.

It is hard to measure the long-term impact of China's economic pressure tactics on the tourism sector until Chinese borders open and normal travel is resumed. Warnings from the Chinese government about its citizens' safety in Australia have alarmed some in the sector. Though so far there has been little indication of a comprehensive and targeted push to dissuade Chinese nationals from travelling to Australia. Even so, tourist arrivals from China, much as Chinese student numbers, are unlikely to return to pre-Covid levels for many years, if ever.



Prior to the pandemic, China was Australia's largest inbound tourist market for both arrivals and spending. Pictured: Sydney Opera House during Vivid Festival (Srikant Sahoo/Unsplash)

In July 2021, when a Macquarie Bank-led consortium made a bid for Sydney Airport, one of the biggest factors weighing on the transaction was future Chinese passenger numbers. Before the pandemic, 100 000 Chinese passengers arrived at Sydney Airport every month, making China the largest single source of

customers for Australia's busiest airport.¹¹² Chinese tourists were responsible for more than a quarter of all spending by foreigners, according to Tourism Research Australia.¹¹³

During the consortium's airport takeover, analysts looked at different scenarios to take account of China's history of using economic coercion in political disagreements. As an example, Beijing put barriers in the way of Chinese tourists going to South Korea after Seoul deployed US missile defence systems against Beijing's wishes in 2016. As a result, the number of Chinese tourists to South Korea dropped from 8.07 million in 2016 to 4.2 million the following year.

Before the pandemic, Chinese tourists rated Australia as the top global destination to visit.

Sydney Airport was not the only commercial entity calibrating future post-Covid Chinese passenger numbers. Tourism operators, hotels, duty free shops, and airlines were asking the same question. However, much as Chinese international students, Chinese tourists increasingly make their own decisions about where to travel. A decade ago, they would have largely travelled as part of group tours. This change means the Chinese government has less leverage to influence individual consumer choices short of a heavy-handed outright ban, which is unlikely.

According to Tourism and Events Queensland, nearly half of all Chinese tourists to the state are independent visitors, and not travelling on package tours. Before the pandemic, Chinese tourists rated Australia as the top global destination to visit.¹¹⁴ Tourism Australia's survey results from May 2021 also indicated a strong desire by Chinese to visit Australia.¹¹⁵

An executive from a Chinese state tourism agency said, "I think it would be safe to say that at the moment, given the hard border rules in China, in the short term, a tourism revival is not likely. However, in the medium and long run, I do believe it will bounce back. At the end of the day, China and Australia are very connected personally. There will always be travel, by students, family, and business."¹¹⁶

A senior executive from one of China's largest online travel companies said he was bullish about the prospect of Australia-China aviation and tourism markets. "The demand is still there, but the market has disappeared. Chinese government policy has destroyed the market," he said. "There is a huge potential for Australia. You only need to look after the top ten million travellers in China. Even seven million will do. That is enough for the Australian market," he said.¹¹⁷

The senior travel executive said China's current Covid-zero border policy had wreaked havoc on the aviation and travel industry, but the market would bounce back very quickly. "Ironically, the most resilient shares in China right now are airline shares, all investors know there is huge pent-up demand." There is reason

Industry experts are not sure whether airline capacity between China and Australia could be sustained, even if pandemic barriers were removed.

to be cautious about a rebound. The significant growth in the number of Chinese tourists to Australia happened on the back of massive expansion of airline traffic, especially after Canberra and Beijing signed an "Open Skies" agreement in 2016 that removed all barriers for seat capacity.¹¹⁸ This significant increase in capacity led to intense competition and drove down fare prices.

However, industry experts are not sure whether airline capacity between China and Australia could be sustained, even if pandemic barriers were removed. This will likely lead to less competition and higher fares. Professor Lei Zheng, a leading expert on the Chinese aviation market from Swinburne University of Technology, says many routes are not profitable and were supported by government subsidies. "Major airlines are currently re-examining their long-haul network. They may exit some unprofitable routes without further local government support."

Many Chinese local governments subsidised airlines in an attempt to turn their local airports into international hubs. Take China Southern Airlines as an example, the largest carrier between Australia and China. Of all its routes, 27 per cent were not profitable before the pandemic. Without subsidies, 40 per cent will no longer be viable. More alarmingly, according to Lei's estimates, 49 per cent of routes run by Chinese airlines are uncommercial without subsidies, which represents nearly half of the capacity between Australia and China. Some industry executives say they will still operate these flights despite unprofitability as they need to deploy their large fleet of long-haul aircrafts.

If a sizeable portion of them stop operating, it will represent a huge loss of airline capacity between the two countries. It is uncertain what kind of impact this would have on Chinese travellers, especially if there were a significant increase in airfares to Australia. This is likely to affect more price-sensitive tour groups than cashed-up independent travellers.

CONCLUSION

Australia is likely to be locked into a sustained, low-level diplomatic conflict, or worse, with China for the foreseeable future. But whatever the nature of the political relationship, Australia's trade fortunes will similarly remain tied to China's economy.

As this analysis shows, the sectors in which Australia appears most dependent on China — iron ore, LNG, and wool — illustrate that the two countries are in fact interdependent. Both countries would be equally damaged by a rupture in trade in these commodities. The key determinant here is still the basic principle of supply and demand. China will continue to buy iron ore and LNG from Australia so long as there are no alternatives. While Beijing cannot change things overnight, it has the desire, and increasingly the ability, to lock down alternative supplies. A lasting legacy of the ruptured relationship between Australia and China could be the creation of a third global player, Guinea, in iron ore. It is a similar story for LNG. With coal, the larger threat to the industry is not China but global climate change policy. Ironically, Chinese banks are financing the industry, while local Australian banks are exiting the sector.

Whatever the nature of the political relationship, Australia's trade fortunes will similarly remain tied to China's economy.

Although geopolitics are changing the tone of the bilateral trade relationship, the global supply and demand dynamics are still the most important determinant for the resilience of the Australian export sector. Even the mighty Chinese Communist Party cannot do much about Australia's favourable geography or geology. Nor could they have foreseen Russia's invasion of Ukraine in February 2022, which has enhanced Australia's value as a reliable supplier of resources and agricultural goods globally.

The pain felt by Australian agricultural exporters varies greatly, both between and within industries. Corporate giants such as Treasury Wine Estates have been able to use their global reach to source their exports to China from outside Australia and begin to alleviate the impact of tariffs. At the same time, many smaller wineries, bottling plants, and label printers have been ruined by Beijing's punitive tariffs. In the meat industry, cattle farmers have enjoyed record prices for their herds even as meat processors are experiencing pain due to diminished access to their most important premium market. A slowing global economy, extreme weather events in many countries, and Australia's own recovery from a long drought all play a role in shaping bilateral trade.

The impact of souring bilateral ties on the student and tourism markets — the Chinese were the largest source country in both instances — is impossible to measure while China's borders remain effectively closed. Airports, hotels, and state tourism agencies remain cautiously optimistic that Chinese tourists will return once Beijing relaxes its draconian zero-Covid policy. But in the case of both students and tourists, the peaks reached in 2019 are unlikely to be repeated in the near term, and in the case of students, probably never.

As China's economy grows and its structure changes and becomes less resource intensive, Australia will likely get a decreasing share of a growing pie.

Chinese investment has plummeted in recent years in parallel with strained bilateral ties.¹¹⁹ Over time, declining investment into Australia is likely to hurt trade. Some proposed investments, including the Chinese offer to buy the Japanese-owned Lion Dairy and Drinks, were vetoed by Australia on national interest grounds. Chinese companies also feel less confident about investing in Australia because they worry that their own government may complicate access to the Australian market or block sales of Australian

goods in their home market. The same is true in reverse. Australian producers will hold back from investing in China because they know their assets could disappear overnight on Beijing's whim.

In short, the core of bilateral trade will remain reasonably strong for some years. But as China's economy grows and its structure changes and becomes less resource intensive, Australia will likely get a decreasing share of a growing pie.

What should Australia do? The obvious answer is diversification to markets other than China. In some cases, such as vineyards that sold nearly all their wine to China, diversification is a pipe dream. But for most producers, it makes sense to look elsewhere at a time when China is willing to target Australian companies to score political points. Emerging economies such as India and Indonesia represent substantial growth opportunities, even if they are not as large or as open, and are not necessarily as complementary to Australia as is China.

But diversification is not the whole story. The areas in which bilateral trade with China have continued to prosper are not the sectors in which Australian producers are dependent on China but where the two countries are interdependent. Australia cannot find alternative markets to match China for commodities such as iron ore, LNG, and wool. Nor can China wean itself off a substantial reliance on Australia as a supplier. It makes sense, then, for Australia to nurture this interdependence, both to benefit the Australian economy and to

maintain leverage of its own. If China wants to diversify from Australia, it should come at a cost, not just to Australia but to China as well.

Beijing's stated national policy, known as "dual circulation", aims both to insulate itself against potential economic sanctions but also to create dependencies that it can deploy as weapons in geopolitical disputes. The core of this policy is aimed at weaning China off any form of reliance on foreign technology. But the same principle extends to commodities. As the Ukraine war has shown, control over commodities has strategic value as well. Australia has maintained its reputation as a reliable supplier of commodities throughout the downturn in bilateral relations with China. It should continue to do so. Australia's interdependence with China in key sectors has benefited both countries economically. Economic enmeshment in critical sectors will not dictate the future course of either country's national security policies, but it can affect China's calculations as geopolitical tensions rise.

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Cover image: Iron Ore Country, Pilbara District, Western Australia (Andrew S/Flickr)

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