Sharing the spoils of China's rise means negotiating some tricky investment twists and turns

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Global changes challenge Canberra's dealings with Beijing

AUSTRALIA stands out among developed economies for its extremely positive attitude towards China's rise.

Many rich countries have been deeply ambivalent about the growing economic heft of the Middle Kingdom, weighing up the costs of higher resource prices, hollowed-out manufacturing sectors and increasingly protectionist-minded voters against the benefits of cheaper imports of manufactures and a dynamic new export market.

But the clear complementarity of the Australian and Chinese economies has encouraged most Australians to see China as an economic good news story.

Yet after several years of surfing the wave of Chinese economic development, the ride has now become a little bumpy, as a surge of Chinese investment into the Australian resources sector has sounded alarm bells in Canberra, Melbourne, Brisbane and Perth.

The rise of Chinese interest in investing in Australia is no surprise.

Until recently, the bilateral economic relationship had been a very lopsided one.

Trade ties were deep, and getting deeper: last year, two-way trade in goods and services reached $58 billion, accounting for almost 13per cent of total Australian trade and making China our largest trading partner.

In marked contrast, investment links have been very modest. The total stock of Chinese foreign investment in Australia at the end of 2006 was a mere $3.4 billion, or less than half of 1 per cent of the value of total foreign investment. Australian investment in China in the same year was similarly small, at $3 billion.

That large gap between the scale of the trading and investment relationships is starting to close. Moreover, it is showing signs that it might do so very quickly.

Over the past two financial years, Australia has approved about $10 billion in proposed Chinese investment, and forecasts for 2007-08 suggest a figure for proposed investment in excess of $30 billion. Not surprisingly, such a dramatic increase has caught the attention of policymakers, as have high-profile deals such as Chinalco's $US14 billion dawn raid on Rio Tinto.

The challenges now being posed by Chinese investment are a product of three major changes in the international economy.

First, emerging markets that used to be seen by the developed world purely as targets for foreign investment are increasingly important foreign investors themselves.

China's role as an overseas investor through its huge accumulation of foreign exchange reserves -- which stood at an astonishing $US1.8trillion in May -- is no longer news, even if its scale continues to amaze.

China is now becoming an important source of foreign direct investment as well.

According to the World Bank, in 2007 China not only continued to be the world's favourite emerging market destination for foreign direct investment, receiving inflows of more than $US84 billion, but it also sent $US30 billion of Chinese foreign direct investment overseas.

Other emerging markets such as India are following suit.

Second, some of these countries give the state a large role in their economies.

As a result, a big share of emerging market outward investment is funnelled through state-owned enterprises, state-owned banks and sovereign wealth funds. This poses a tricky dilemma for developed-world policymakers.

The latter have spent the past couple of decades convincing their voters that the private sector, not government, should take the lead in managing most businesses.

At the same time, they have stressed the important benefits that come from openness to foreign investment.

When confronted by government-controlled foreign investment, one of these propositions has to give. A key question now facing politicians, from Washington to Canberra, is: which one?

Third, the industrialisation and urbanisation of the world's most populous economies -- China and India between them account for more than one in three of the world's people -- has powered the current global resources boom. This in turn has triggered resurgent resources nationalism among some producers and a focus on resources security on the part of big consumers such as China, simultaneously making the resources sector an attractive and sensitive target for foreign investment.

Given that these profound changes in the global economy are also contributing to a major shift in the Australia-China bilateral relationship, do they call for a similarly dramatic change in Australia's foreign investment policy framework?

No. Five issues are relevant here.

First, at the moment the majority of foreign investment into Australia is not seen as threatening our national interest in any way, whether by virtue of its size or the particular sector into which it is headed.

For the same reasons, for a whole range of prospective deals this won't change even if the investor concerned is linked to a foreign government, Chinese or otherwise.

Second, there are some strategic sectors or large-scale deals that will trigger sensitivities regardless of whether the foreign investor is government or privately controlled.

Here, the existing framework already provides the Treasurer with plenty of scope to intervene. Indeed, the veto of Shell's attempted takeover of Woodside in 2001 prompted criticism that there was already too much discretion available, not too little.

Third, this leaves those cases where Canberra will decide, quite rightly, that while a private sector investor is acceptable, a government-controlled one isn't. Again, the current framework already provides for this. It allows the Treasurer to set appropriate conditions to mitigate specific concerns, for example. That might still leave some cases where an outright veto will be required. But the number is likely to be quite small.

Next, there is the issue of reciprocity. Australia is currently negotiating a free trade agreement with China, and Beijing will be pressing Canberra for concessions relating to Chinese investment. Others will follow.

A request for reciprocal treatment for Australian investment is the appropriate response.

Finally, it is important to keep the current debate in perspective. Despite the policy challenges involved, clearly China's rise is still an economic good news story for Australia.

It's just that it's turning out to be a more complicated story than it first appeared.

Mark Thirlwell is director of the international economy program at the **Lowy Institute** for International Policy. He will speak on this subject at a conference in Melbourne on Friday organised by the Australia China Business Council, the **Lowy Institute** and the faculty of business and economics at the Monash University.