**The London School of Economics and Political Science**

# Complex Interdependence and China's Engagement with Australia

--- Navigating between Power and Vulnerability

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A thesis submitted to the Department of International Relations of the London School of Economics for the degree of Doctor of Philosophy, London, October 2014

## Declaration

I certify that the thesis I have presented for examination for the MPhil/PhD degree of the London School of Economics and Political Science is solely my own work other than where I have clearly indicated that it is the work of others (in which case the extent of any work carried out jointly by me and any other person is clearly identified in it).



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# Abstract

China has become heavily dependent on Australia for resource supply as a result of her rapid economic growth over the 2000s. Stable and reliable resource supply from Australia has become a matter of national economic security. Yet, China's resource relationship with Australia is grown out of a delicate geopolitical framework, because Australia is not only a resource superpower but also a staunch U.S. ally in the Asia-Pacific region. Despite extensive economic interdependence between the two countries, China faces a huge challenge to build a genuinely reliable and close resource partnership with Australia. This study discusses how China has proactively sought to shape or adapt to the evolving power dynamics behind the bilateral resource politics over the 2000s. It provides a relevant case study on the resource politics between a rising great power and a resource superpower under the condition of complex interdependence.

China's search for resource security has become the primary goal of her policy towards Australia in the 2000s. However, China's engagement with Australia has led to an uneasy resource partnership with growing competitive dynamics and constant power struggle. The political context of the resource ties between China and Australia has changed dramatically towards the end of the 2000s, as the systemic impact of China's rise has resulted in a deterioration in the strategic dimension of China-Australia relatoions. This has in turn created considerable constraints and uncertainties in China's resource cooperation with Australia. Both the difficult resource investment ties and the inequitable iron ore trade relationship show the limits of this resource partnership. Australia's approach to this critical resource relationship with China remains *ad hoc*, transactional and oriented to short-term interest maximisation. Despite her growing power, China remains the more vulnerable party in the uneven resource interdependence with Australia. The Chinese have sought to improve their power position vis-à-vis the Australians; but domestic economic constraints and internal fragmentation have considerably undermined Chinese efforts to gain the upper hand in the bilateral resource politics. China has to navigate cautiously between power and vulnerability in her engagement with Australia.

# Acknowledgements

I have been extremely fortunate to undertake research in International Relations at the London School of Economics and Political Science (LSE).

In particular, I would like to register my indebtedness to my supervisor, Professor Christopher R. Hughes. This thesis would never have been completed without his guidance and support. Throughout my studies, Professor Hughes has provided an endless source of enormous intellectual inspiration. His kindness and encouragement have always helped me find the strength to persevere.

I could not have completely my research without the continuous financial support of the LSE International Relations Department (IRD). The IRD Research Studentship and fieldwork grants have significantly reduced my financial burden.

I would also like to express my gratitude to all my interviewees who have given their time during my fieldwork in China and Australia. I am deeply grateful for their insights and assistance.

I am deeply grateful to my examiners, Professor Shaun Breslin and Professor Toby Dodge, whose feedback and criticism have been most helpful in the revision of this thesis.

Lastly, I would like to thank my family for their unfailing support, patience and encouragement.

I alone am responsible for any shortcomings the thesis may have.

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# List of Abbreviations

| | |
|---|---|
| ABC | Australian Broadcasting Corporation |
| ACCC | Australian Competition and Consumer Commission |
| ACFIC | All-China Federation of Industry and Commerce |
| ACT | Australian Capital Territory |
| ADF | Australian Defence Force |
| ADFA | Australian Defence Force Academy |
| ANU | Australian National University |
| ANZUS | Australia, New Zealand, United States Security Treaty |
| ASEAN | Association of Southeast Asian Nations |
| ASPI | Australian Strategic Policy Institute |
| ASX | Australian Securities Exchange |
| AUSMIN | Australia-United States Ministerial (Consultations) |
| CAITEC | Chinese Academy of International Trade and Economic Cooperation |
| CASS | Chinese Academy of Social Sciences |
| CCCMC | China Chamber of Commerce of Metals, Minerals & Chemicals Importers & Exporters |
| CDB | China Development Bank |
| CIC | China Investment Corporation |
| CICIR | China Institutes of Contemporary International Relations |
| CIF | Cost, Insurance & Freight |
| CIIS | China Institute of International Studies |
| CISA | China Iron and Steel Association |
| CIW | Australian Centre on China in the World |
| CMA | China Mining Association |
| CPC | Communist Party of China |
| DFAT | Department of Foreign Affairs and Trade |
| DFPR | Defence Force Posture Review |
| EAS | East Asia Summit |

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|---|---|
| EU | European Union |
| FATA | Foreign Acquisitions and Takeovers Act |
| FDI | Foreign Direct Investment |
| FIRB | Foreign Investment Review Board |
| FOB | Free-on-Board |
| FTA | Free Trade Agreement |
| GDP | Gross Domestic Product |
| GFC | Global Financial Crisis |
| GOA | Government of Australia |
| IR | International Relations |
| MIIT | Ministry of Industry and Information Technology |
| MMAC | Metallurgical Mines' Association of China |
| NATO | North Atlantic Treaty Organisation |
| NDRC | National Development and Reform Commission |
| PE | Private Equity |
| PLA | People's Liberation Army |
| PRC | People's Republic of China |
| SASAC | State-owned Assets Supervision and Administration Commission |
| SASS | Shanghai Academy of Social Sciences |
| SIIS | Shanghai Institutes for International Studies |
| SOE | State-owned Enterprise |
| TSD | Trilateral Security/Strategic Dialogue |
| UN | United Nations |
| UNSW | University of New South Wales |
| WMD | Weapon of Mass Destruction |
| WTO | World Trade Organisation |

# Chapter 1 Introduction

## 1.1 Background: China’s Rise and Relations with Australia

### 1.1.1 Predominance of Extensive Economic Interdependence

China’s phenomenal economic rise has taken place during an era of economic globalisation, and its' entry into the World Trade Organisation (WTO) in 2001 has ushered in a new era of economic development and rapid economic growth. China has emerged as the world’s second largest economy measured by gross domestic product (GDP), leading the shift in global power and the collective rise of the emerging economies across the globe. The country's rising economic salience is further accentuated by the relative decline of the West following the 2008-2009 global financial and economic crises. The rise of Chinese economic power has also been accompanied by the perceived growth of its' military capabilities. China has come to be regarded as a formidable strategic force with the potential and ambitions to challenge the United States' strategic primacy. The rise of the Chinese economy and military is transforming the structure of the international system and the U.S.-led world order. Accordingly, China’s rise is also reshaping the underlying power structure of Chinese-Australian relations. By the early 2010s, the growing power disparities between these two countries – a middle power and a near, if not realised, superpower – is increasingly resulting in an unequal power relationship.

In the bilateral context, China’s rise vis-à-vis Australia is first and foremost a result of the development of robust resource ties between the two countries during the 2000s. China’s strong economic growth and the pattern of her economic development have fuelled an insatiable demand for resources and raw materials. As China has become the world’s largest consumer of resources, Australia, as a ‘resource superpower’, has emerged as an increasingly vital resource partner for China.

Bilateral relations between China and Australia, in terms of trade and investment, are dominated by resource ties.[1] This growing resource partnership has led to a continuous surge in bilateral (merchandise) trade since the 1990s. Thanks to surging demand in China for Australian minerals (most notably iron ore, which constitutes the bulk of the bilateral resource trade) and energy resources (such as coal and natural gas), China overtook Japan in 2007 to become Australia’s largest resource buyer and merchandise

[1] Interview: 24

export market. Australia has also emerged as the top destination for China's outbound direct foreign investment and become home to some of China's largest overseas foreign direct investment (FDI) projects and proposals. Indeed, China is now the largest emerging FDI investor in Australia. As a result of an ambitious strategy to acquire Australia's resource assets, a rapid surge in Chinese direct investments, mostly undertaken by government-related investment entities, was registered in the second half of the 2000s.

The resource business has formed the backbone of the bilateral relations and underpinned the extensive economic interdependence between China and Australia. Australia has become a major overseas resource supplier for China, and in turn China has become the key to Australia's future economic prosperity as it embraces what has been termed the Asian century. The development of this resource partnership has fuelled the rapid expansion of the Australian resources sector, and the mining boom has become the key driver of the Australian economy and a major reason behind the country's continued economic success despite the recent global financial and economic crises.

Beyond the vital resource ties, the bilateral relations also encompass a security dimension, which reflects the strategic dynamics between China and Australia. Although the bilateral economic relationship centred on resource cooperation has dominated the agenda, this security relationship has never been far from strategic significance. In fact, the security dimension has always remained an important area of policy deliberation for both the Chinese and Australians, even when the bilateral relations seemed to have been overwhelmed by the resource engagement. This is not, however, simply because the strategic dynamics have already started to complicate the economic dealings between the two countries. If anything, the state of this security relationship always carries a great influence over the overall political direction of Chinese-Australian relations, in terms of the basic pattern of amity and enmity between them. This was the case during the decade of the 1990s following the end of the Cold War and has also been true during the 2000s, when the overall bilateral relationship has been increasingly shaped by the economic imperative of resource cooperation. The security dimension will gain increasing salience in the bilateral context when the strategic implications of China's rise further complicate the security dynamics between China and Australia, with global repercussions.

Sino-Australian security ties have undergone several stages of transformation from the 1990s through the post-9/11 period and into the post-crisis era. These changing patterns are part of a broader strategic transformation that continues to unfold as a result of China's rise to global power. Insofar as the 2000s are concerned, the 9/11 incident as well as the global financial and economic crises at the end of the decade, resulted in a series of systemic changes in the global and regional strategic circumstances under which China's security relationship with Australia evolved. The shifting power balance between China and the United States, evolving Chinese strategic behaviour and U.S. security priorities, have had a huge impact on U.S.-China relations and the Asia-Pacific regional security environment. Changes in these systemic factors contributed to a delicate security relationship between China and Australia. As an integral part of the strategic triangle between Beijing, Canberra and Washington, the Chinese-Australian security relationship remains inherently uncertain and precarious, not least because of irreconcilable ideological differences, deep-seated mutual distrust, opposing outlooks on American hegemony, and conflicting long-term strategic preferences.

It is true that as a middle power, the only Western power in the Western Pacific, and a significant security actor in the region with a robust alliance relationship with the United States, Australia has occupied a special place in China's foreign policy considerations. From the Chinese perspective, the fact that Australia is geographically the most proximate Western country and America's closest ally in the region, has added significance to China's relationship with Australia. The Chinese have come to regard the political relationship with Australia as having a special meaning following post-9/11 strategic rapprochement. Indeed, the Chinese leaders began to view China's relationship with Australia as an exemplary model for relations between China and the West.[2] The resultant Chinese enthusiasm for a strategic partnership with Australia provides an insight into the importance Beijing attached to China's political ties with Canberra. The deterioration in the security relationship after 2008 caused some anxiety for the Chinese. Arguably, the changing alliance dynamics between Australia and the United States in the post-crisis era and Australia's place in America's Asian pivot strategy, reinforced China's strategic anxiety and further accentuated Australia's strategic significance for the Chinese amidst a deteriorating regional security environment.

[2] Interview: 27

Having said that, Australia nonetheless remains a distant power in China's strategic thinking. It is close enough to be generally considered as part of the region, but too far away (both geographically and culturally) to be considered an East Asian regional country by the Chinese.[3] Despite her location in the Western Pacific, Australia at best belongs to the 'greater/outer peripheral region' (*dazhoubian*). Although Australia is a significant security actor in the Asia-Pacific region, Australia, unlike countries such as Japan and even South Korea, is not a strategically or politically important regional power that necessitates China's constant attention, insofar as the Chinese strategic policy is concerned. Hence, the security dimension of the bilateral relationship no longer consistently dominates the agenda of the bilateral politics. Rather, the traditional military security agenda has had to constantly compete with resource-focused economic affairs for policy attention, both in Beijing and Canberra.

Although both resource ties and security relationships still constitute two very important dimensions of Chinese-Australian relations, it is the resource relationship that has become the primary concern of both countries. The security relationship remains important in its own right, but China's economic rise in the new century has demoted the security dimension to second place, whether in comparison with its relative significance in the 1990s (and early 2000s), or as compared with the economic dimension. If anything, the bilateral resource engagement has acquired overriding importance. After all, Chinese-Australian relations have been built on the back of the resource partnership.

Arguably, if the post-2008 security relationship is said to have taken on a new meaning, it is the vital resource partnership that has given additional weight to it, especially from the Chinese perspective. If economic statecraft is defined in terms of the use of economic inducements or coercion to achieve political and security goals,[4] China's policy towards Southeast Asian countries more or less reflect an

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[3] Interviews: 6, 37

[4] According to *The Penguin Dictionary of International Relations*, economic statecraft is defined by David Baldwin as 'influence attempts relying primarily on resources which have a reasonable semblance of a market price in terms of money'. In other words, economic statecraft 'is any political act which utilises economic instruments to achieve compliant behaviour from a Target actor… Economic statecraft may appropriately be regarded as an umbrella term covering all instances where international actors use economic instruments for political ends' (Evans & Newnham, 1998: 145-146).

overriding geopolitical imperative of strategic reassurance and inducement through the use of economic statecraft. By contrast, nowadays China's approach to Australia is not dominated (or primarily driven) by the same geo-strategic logic of economic statecraft. Despite the fact that the growing economic interdependence that flows from the robust resource partnership has had a stabilising effect on the bilateral security relationship since the late 1990s, the Chinese motivation behind the growing resource partnership with Australia has increasingly taken on a momentum of its own, and is primarily developmental in nature. There has always been a growing incentive to tap into the burgeoning economic relationship given its huge strategic dividend.[5] Nonetheless, China's economic engagement with Australia has first and foremost been driven by the developmental imperative of resource security; and Chinese foreign policy towards Australia during the 2000s has increasingly been characterised by a geo-economic agenda, with the aim of making Australia a reliable major resource supplier for China.

As Chinese-Australian relations were transformed by China's rise during the 2000s, it is interesting to observe how China's rise has shaped the dynamics of power politics between the two countries. In light of the central role resource cooperation has played in advancing the bilateral relations, it is necessary to explore the implications of China's growth in power for the resource power politics between the two countries. As the 2000s was characterised by economic globalisation and the initiation of a global shift in power, it is all the more important to explore resource power politics between China and Australia in the context of growing economic interdependence and the evolving security dynamics during the course of the decade. In short, this thesis's analysis of China's resource power politics vis-à-vis Australia is undertaken against the background of China's rise, extensive economic interdependence and changing strategic dynamics in the bilateral security relationship with Australia.

### 1.1.2 Paradox between Growing Power and Vulnerability

To some extent, China's rise has become almost a testament to the success of economic globalisation and is leading the global power shift. Despite her rising power, China remains vulnerable to a series of structural constraints at home and within the international system. Whilst the nation's rising power is often taken for granted, her vulnerability has so far remained less discernible, often overshadowed and

[5] Interview 16

eclipsed by the confusion and thrills produced by the former. Yet, rising power and entrenched vulnerability do constitute a real paradox of China's rise. An ascendant China has to face the dual challenge of adapting to her increasing power and coping with her vulnerability. The interplay between power and vulnerability has created considerable uncertainty about the way in which China would use her power, respond to her vulnerability and handle her foreign relations. This thesis attempts to engage this paradoxical dimension of China's rise.

This paradoxical nature of China's rise sets the theme for this study in the context of China's bilateral relations with Australia. As this thesis will show, the challenge of navigating herself through this paradox is a real and hard test of Chinese foreign policy. The processes and outcomes of China's resource power politics vis-à-vis Australia demonstrate that China has to make painstaking efforts to strike a fine balance between strength and vulnerability, seeking to maximise the gains with the growing power at her disposal whilst avoiding the pitfalls of misjudging the constraints imposed by its vulnerability. Failures to understand the limits of her power and the logic of her vulnerability can be costly in policy terms for the Chinese. Unless China can come to grips with the implications of the growing tensions between her rising power and vulnerability, it is unlikely that the country will be able to implement a policy with sufficient depth and coherence in her quest for resource security with Australia.

It is important to emphasise here the distinction between the different possible meanings of the word 'vulnerability'. The word 'vulnerability' is not used in the context of this study to mean 'fragility', though the two words could have some overlapping connotations. This study uses the concept of vulnerability as construed by Robert Keohane and Joseph Nye in their seminal text of neoliberalism – *Power and Interdependence*. The theoretical definition of this concept is however relatively abstract, so it will be discussed in the subsequent section on the thesis' theoretical framework in this chapter. To put it simply, at least insofar as this study is concerned, 'vulnerability' basically refers to a situation where one is faced by an unfavourable position but lacks sufficient options or autonomy to change that unfavourable position; this is because such options are either unavailable or too costly and the constraints are too immense to overcome. Indeed, this notion of vulnerability captures the essence of the Chinese word '*beidong*' (被动), which in fact is often used to refer to China's relatively unfavourable position vis-à-vis the United States, which, more often than not, dominates the bilateral relations over a variety of issues areas. Given the existing power disparities between China and the United States, the United States' advantageous power position vis-à-vis China has allowed the former to enjoy a favourable power position in the bilateral dealings vis-à-vis China.[6] The sense of vulnerability (or *beidong*) therefore used to characterise the Chinese foreign policy thinking on China's relations with America as the Chinese endeavour to maintain their room for manoeuvre under U.S. predominance; to get rid of the vulnerable position has always been an important foreign policy imperative for Beijing in the power politics vis-à-vis Washington.[7] In this regard, *zhudong* (主动) is the very antithesis of *beidong* (被动) in the Chinese strategic thinking. In plain English, the word '*zhudong*' entails a great amount of room for manoeuvre in whatever situations; to some extent, the meaning of '*zhudong*' echoes the idea of 'the initiative', which basically means (one has) 'the power or opportunity to act and gain an advantage before other people do'.[8] In this regard, the idea of getting rid of vulnerability (*baituo beidong*) and the notion of seizing the initiative (*zhengqu zhudong*) are basically two sides of the same coin.

From the Chinese perspective, the situations of *beidong* (vulnerability) and *zhudong* essentially reflect states' relative power position vis-à-vis other states.[9] Accordingly, as China's power continues to grow, the strategic goal of seeking greater foreign policy autonomy and striving for greater freedom of manoeuvre is thought to have somehow become relative easier to attain. Indeed, this new thinking reflects growing Chinese confidence in foreign affairs and would arguably push back the boundaries of Chinese ambitions. Arguably, China's growing power is also likely to diminish her tolerance for her vulnerability;[10] for a rising potential superpower, the need to overcome her vulnerability and seek greater strategic initiatives would only become ever more pressing for Chinese foreign security and economic

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[6] See interview with Wang Jisi: http://www.nfcmag.com/article/2139.html

[7] See various discussions of this strategic thinking by Chinese military and foreign policy strategists: http://dangshi.people.com.cn/GB/18003056.html; http://www.globalview.cn/ReadNews.asp?NewsID=516; http://www.nfcmag.com/article/2139.html; http://www.ciss.pku.edu.cn/ueditor/net/upload/file/20140813/6354348760247173005423273.pdf; http://www.dfdaily.com/html/8762/2012/9/18/863587_2.shtml; http://opinion.china.com.cn/opinion_37_83437.html; http://mil.huanqiu.com/observation/2014-10/5160549.html

[8] See Oxford Dictionary: http://www.oxfordlearnersdictionaries.com/definition/english/initiative

[9] See interview with Wang Jisi: http://www.nfcmag.com/article/2139.html

[10] See relevant discussions of China's diminishing tolerance by Zhang Yunling and Wang Jisi: http://www.dfdaily.com/html/8762/2012/9/18/863587.shtml; http://www.ciss.pku.edu.cn/ueditor/net/upload/file/20140813/6354348760247173005423273.pdf

policies alike.

China's resource power politics vis-à-vis Australia has already demonstrated such dynamics in Chinese strategic thinking. In essence, this thesis is telling a story about the Chinese response to the interplay between China's vulnerability and growing power in the search for resource security with Australia. From the Chinese perspective, this is a story about China's struggle to get rid of her vulnerable position (*baituo beidong jumian* 摆脱被动局面) and seek the upper hand (*zhangwo zhudong* 掌握主动) in the resource power politics vis-à-vis Australia.

In the light of the central role of the resource ties in the bilateral relations, it is interesting to see how the paradox between growing power and vulnerability is played out in the resource power politics between the two countries. Indeed, as the empirical analysis will demonstrate, this study is very much focused on the Chinese vulnerability in the resource power politics against a background of a rising great power seeking to maximise her resource security interest. Moreover, given the nature of the China-Australia relations as outlined previously in this section, it is all the more important to explore the resource power politics by taking account of both the extensive economic interdependence and the evolving security dynamics between China and Australia over the 2000s; in other words, the interplay of forces of economic globalisation and power shift also constitutes a crucial analytical background in this study.

From the Chinese perspective, the bilateral resource politics basically focuses on two issue areas: the transnational battle between the Chinese steel industry and Australian iron mining oligarchs for iron ore pricing power, and the political struggle over Chinese government investment in Australia's resources sector. Whilst the former represents the politics of resource trade, the latter illustrates the politics of resource investment. The reason for this focus is that the bilateral resource power politics is most intensely played out in these two issues areas as both sides have immense interests at stake in the outcomes of the power struggles. Moreover, these two issues areas are most reflective of the underlying patterns of the relative power relationship between China and Australia.

As this study will show, Australia has enjoyed considerable advantages in terms of resource power, and the Chinese seek to change this unfavourable status quo. The Chinese actors have been striving for increased Chinese ownership of resource assets in Australia and control of resource prices. By leveraging China's enhanced market status and new-found financial power in the power politics vis-à-vis the Australians, the Chinese aim to beef up China's market influence and secure reliable supply of Australian resources at reasonable prices. For the Australians, the challenge is how to sustain and expand the lucrative resource business with China and maximise the gains and benefits from China's economic rise through the resource ties, while at the same time preserve and protect the country's dominance as a resource superpower in terms of Australian control of quality resources and their pricing. By looking at the Chinese experience in these struggles for resource power, this thesis hopes to shed light on how China tackles the contradiction between rising power and vulnerability in her relations with Australia.

## 1.2 Research Topic and Purpose

The aim of this research is to analyse China's engagement with Australia in the context of China's rise during the 2000s. More specifically, it investigates China's resource interaction with Australia.

This thesis is primarily concerned with the power politics of economic interdependence. It looks at how the power dynamics behind the bilateral resource politics evolve in the context of China's rise, and how China responds to the dynamic pattern of resource politics.

The study draws on neoliberal International Relations (IR) theory of complex interdependence in conjunction with the neoliberal perspective on the power politics of asymmetrical interdependence, to explain China's resource politics vis-à-vis Australia.

### 1.2.1 Research Question

How has China sought to shape and adapt to the evolving power dynamics behind the bilateral resource politics with Australia in the 2000s?

### 1.2.2 Research Objectives

In order to address the core research question, the study will seek to accomplish the following objectives:

1 To examine the geopolitical context of Chinese-Australian resource politics and to understand the strategic constraints faced by China;

2 To assess the basic pattern of China's power position vis-à-vis Australia in the struggle over Chinese investment in Australia's resources sector and the battle for iron ore pricing;

3 To analyse the roles and interests of various Chinese actors involved in Sino-Australian resource politics;

4 To explain the Chinese and Australian responses and how they have shaped the power dynamics of the bilateral resource politics;

5 To discuss the broader implications of Sino-Australian resource politics for complex interdependence theory and China's foreign policy.

### 1.2.3 Overarching Argument

This thesis argues that China does not enjoy a superior power position vis-à-vis Australia in bilateral resource politics under complex interdependence theory. Despite her perceived rising economic power, China has failed to gain the upper hand in the issue-specific power politics versus Australia in the iron ore pricing war and in the controversy over Chinese resource investment in Australia. The Chinese have sought to redress the unfavourable patterns of asymmetrical vulnerability interdependence in the bilateral resource power politics vis-à-vis the Australians. However, these efforts have been seriously undermined due to domestic constraints, which have significantly contributed to Chinese vulnerability.

Realist dynamics in the strategic dimension of the bilateral relations have also imposed significant geopolitical constraints on the development of the resource ties. As China's strategic relations with Australia continue to be strained by the revived adversarial dynamics in response to China's rising power, the development of resource ties with Australia faces growing strategic risks.

Hence, despite the perception of China's rise and the country's favourable power position in terms of the overall power asymmetries between China and Australia, China nonetheless faces significant international political and domestic constraints in her search for resource security. In order to protect her resource security interests, China has to cautiously navigate between rising power and vulnerability in her relations with Australia.

### 1.2.4 Chapter Outline

**Chapter 2**

Chapter 2 discusses the changing patterns of China's security relationship with Australia over the 2000s. This strategic dimension of the bilateral relations defines the political framework under which the economic partnership between China and Australia develops. In no small measure, China's increasingly vital resource partnership with Australia was grown out of a highly dynamic and difficult geopolitical context. The purpose of this chapter is to provide the geopolitical context in which the bilateral resource politics was played out. It discusses the strategic dimension of the bilateral relations by investigating the evolving trajectory of the changing strategic dynamics between the two countries in the post-9/11 and post-2008 eras respectively.

The chapter argues that China's delicate strategic relations with Australia underwent some major changes in the first decade of the new century. The bilateral relations improved significantly during the post-9/11 era that featured a steady warming-up of the bilateral relations; but since 2008 there was a serious deterioration in the strategic dimension of the bilateral relations. China's growing power and expansionist behaviour following the global financial crisis brought about a chain of systemic changes that had led to a deteriorating regional strategic environment, characterised by intensified tensions in China-U.S. relations, changing U.S. regional strategic posture, and heightened strategic rivalry in East Asia. The deterioration in China-Australia strategic ties since 2008 was part of this wider geopolitical change.

The geo-strategic context set out in this chapter underlines the geopolitical constraints faced by China in her bilateral resource power politics vis-à-vis Australia. By illustrating the ups and downs in the bilateral relations during the post-9/11 and post-2008 eras respectively, the strategic analysis in this chapter set out the wider geopolitical context for the issue-specific analysis of bilateral resource politics in the subsequent chapters. It helps readers better appreciate the delicate strategic context of the bilateral resource ties and its ensuing implications for the development of this resource partnership. As the subsequent chapters will illustrate, the precarious nature of this bilateral political relationship had seriously limited the potential for economic cooperation and precluded China and Australia from establishing a reliable and intimate resource partnership.

**Chapter 3**

Chapter 3 is concerned with the investment aspect of the bilateral resource politics. More specifically, it discusses the power politics over Chinese investment in Australia's resources sector. The Chinese government investors flocked to Australia in search of greater control of resource assets over recent years. The rapid surge in China's government-related foreign direct investment in the Australian resources sector since 2008 caused a huge controversy and Australia sought to restrict Chinese government investment in order to protect her national interests. The controversy over Chinese government investment in Australia highlights one of the most important and thorny aspects of the evolving resource ties between China and Australia. This is therefore an arena in which the power dynamics behind the politics of resource relationship is most intensely played out. The purpose of this chapter is to illustrate the power dynamics behind this investment politics. By examining the Chinese efforts to shape and adapt to the power politics of China's dynamic resource investment relations with Australia, it seeks to answer the research question and throw light on the limits of the bilateral resource investment ties and the nature of the resource partnership.

This chapter argues that China's resource investors were vulnerable to Australian restrictions on foreign government investment. Despite their great financial power and mercantilist ambitions, the Chinese investors had no choice but to adapt to Australia's rather stringent and restrictive foreign government investment regime because the favourable underlying patterns of asymmetrical vulnerability interdependence. China carried out a mercantilist strategy of resource acquisition in Australia via her government investment vehicles in an attempt to enhance Chinese control of Australian resource assets. The Australian authorities were determined to protect Australia's resource domination by blocking and restricting China's government investment in the country's resources sector to protect Australian dominance in the resource relationship. China's apparent vulnerability in the resource investment politics was in stark contrast to the general perception of growing Chinese power that was derived from the phenomenal surge of Chinese investment in Australia's resources sector. When it comes to assessing the real power relationship between China and Australia in the specific area of resource investment, the reality of Chinese vulnerability is a more accurate indicator than the overwhelming yet misleading sense of rising Chinese purchasing power that had engulfed Australia. The findings of this chapter reinforce the conclusion of the thesis, which argues that China has to cope with her vulnerability in her resource politics vis-à-vis Australia despite her perceived growing power.

Having demonstrated Chinese vulnerability in the face of the Australian policy restrictions on Chinese government investment, this chapter also illustrates the limits of the resource partnership by highlighting the limited scope of the resource investment ties. The intense power struggle and complex political manoeuvres on both sides have clearly showed the lack of trust and depth in the resource cooperation that had seriously impinged the development of a genuinely reliable resource partnership between China and Australia.

**Chapter 4**

Whilst the politics of resource investment is an important dimension of the resource politics, the politics of resource trade constitutes another crucial aspect of the bilateral resource power politics, especially pertaining to the distribution of gains from the bilateral resource cooperation. China's gigantic demand for iron ores resulted in growing prices of imported iron ores from Australia and elsewhere. Inspired by the growing salience of the Chinese market in the global iron ore trade, the Chinese steel industry endeavoured to fight a 'war' against the dominant Australian miners over the iron ore import prices in response to the miners' attempts to raise ore prices. The battle for iron ore pricing power was another most important aspect of China's resource politics with Australia because the iron ore trade constituted the bulk of the bilateral resource trade and both sides had immense interests at stake.

In fact, there is an inherent causal relationship between the battle for iron ore pricing and the struggle over Chinese resource investment in Australia, not least because China's aggressive investment spree in Australia was in no small measure a direct response to the Chinese predicament in the iron ore trade with the Australian miners. China's entrenched vulnerability in the power struggle over iron ore pricing was costly and taught the Chinese a most painful lesson about the importance of gaining control of the upstream resources for the survival of downstream resource-dependent industries. After all, China's experience in the iron ore pricing debacle had led the Chinese to believe that increased ownership and control of upstream iron ore resources in Australia could significantly enhance the Chinese market influence over iron ore pricing and increase downstream steel makers' ability to absorb the costs of surging raw material costs. This market logic was apparent behind many of the huge Chinese investment adventures into Australia's iron ore assets. Arguably, the Chinese experience in the transnational struggle over iron ore pricing had greatly influenced the Chinese geo-economic thinking about the mineral resource strategy at both the national and corporate levels. In other words, if the Chinese resource investment in Australia was ultimately aimed at acquiring a dominant market influence centred on the control over resource pricing, then the iron ore pricing issue could be regarded as the 'fuse' for the great controversy over Chinese investment. In this regard, the power politics over Chinese resource investment was essentially a continuation of the power politics over iron ore pricing between China and Australia. To fully appreciate the geo-economic and market rationales behind China's thirst for market power in Australia's resources sector, one has to look at the trade dimension of this resource partnership; and the iron ore pricing war is the most relevant starting point in this regard.

Chapter 4 will discusses this important dimension of the resource politics by looking into the power politics of the transnational struggle over iron ore pricing power between China's steel makers and the Australian mining oligarchs. Its purpose is to answer the thesis' research question by analysing how the various Chinese industry actors endeavoured to shape and adapt to the evolving power dynamics behind the transnational battle over iron ore pricing power against the dominant Australian miners.

This chapter argues that the Chinese steel makers remained completely vulnerable to the Australian pricing initiatives to raise the ore price. Rising iron ore import costs had depressed the profit margins of steelmakers; the deterioration in the Chinese steel industry's earnings performance since the global financial crisis rendered the surging raw material costs increasingly intolerable towards the end of the 2000s. As a result, the iron ore price issue was politicised and became a matter of national economic security in China; it emerged as an important policy agenda for China in her bilateral relations with Australia. However, In the face of the miners' dominant pricing power, China's steelmakers failed to exert any effective influence over the iron ore prices and pricing mechanism. In this regard, both the underlying patterns of sensitivity and vulnerability were working against the Chinese side. Despite the fact that China had emerged as the world's largest iron ore importing country and the biggest export market for Australian iron ores, the Chinese had failed to translate the country's overall market position into real market power over commodity pricing in the iron ore pricing war, and were forced to adapt to the Australian dominance over the iron ore trade, even when the surging raw material costs and a deteriorating Chinese economic environment had almost brought the entire Chinese steel industry to its knees. China still lacked and failed to acquire the market influence over iron ore price and pricing regime that was commensurable with the country's overall market size in the global iron ore trading business. The main argument of this chapter is consistent with the thesis' central argument that China has to navigate between vulnerability and power in her resource politics vis-à-vis Australia.

If anything, the iron ore pricing war illustrated the subjugation of the Chinese steel industry by the Australian mining oligarchs in the political economy of iron ore trade. The vast power disparities between the Chinese ore buyers and the Australian ore suppliers allowed the latter to profit immensely from the lucrative ore business by taking advantage of the Chinese vulnerability. Such inequitable terms of resource trade were consistent with the changing nature of the geopolitical ties between the two countries. Like the resource investment ties, the trade relationship was also grown out of a delicate and precarious geopolitical framework. The revived strategic tensions and even growing adversarial dynamics observed over recent years in the bilateral strategic relationship had rendered the broader political context increasingly difficult for the development of a truly equitable and harmonious resource trade partnership.

**Chapter 5**

The previous chapter has also briefly discussed the ways in which the Chinese endeavoured to reduce the country's dependence on the three dominant miners. Efforts such as increasing China's indigenous iron ore supplies and Chinese-owned iron ore assets abroad were all supply-side strategies that aimed at undermining the three mining oligarchs' monopoly control of iron ore supply and strengthening Chinese market power. Those measures were essentially supply-side strategies to reduce Chinese dependence on the major iron ore suppliers. However, such efforts could hardly undermine the dominant market power of the three mining oligarchs or help significantly reduce Chinese dependence on them in the short term.

This chapter will look into the demand-side Chinese deliberations to tackle China's vulnerability in the iron ore pricing war. It will examine in detail how the various domestic economic constraints significantly contributed to Chinese vulnerability in the battle for pricing power and explain why it was so difficult for the Chinese to get rid of those domestic constraints under complex interdependence.

The Chinese side encountered enormous domestic obstacles to improving the Chinese power position in the transnational iron ore price struggle. In no small measure, the Chinese predicament in the iron ore pricing war was the spillover created by those domestic obstacles. In order to have a deeper understanding of the sources of the Chinese vulnerability in the iron ore pricing war, this chapter considers those domestic constraints on the Chinese actors by mainly looking into two major issues: the rampant speculative trading in China's iron ore import market, and the steel industry's structural problems.

These two situations had considerably aggravated the Chinese predicament in the iron ore struggle by popping up Chinese demand for imported iron ores and depressing steelmakers' profit margins. By tracing the various internal constraints behind these two situations, Chapter 5 seeks to shed light on the internal sources of Chinese predicament in the transnational struggle for resource pricing power.

The analysis of the domestic sources of Chinese vulnerability is a very important step to answer the thesis' research question and some of the research objectives. It is not only necessary for understanding the roles and interests of the various Chinese actors involved in the struggle for pricing power, but also extremely crucial for understanding China's disadvantageous power position vis-à-vis Australia and why the various Chinese endeavours in the transnational power politics of resource trade always failed to enhance China's bargaining power. Hence, though the analytical focus of this chapter is domestic-oriented, it nonetheless constitutes an integral part of the empirical analysis of China's resource power politics vis-à-vis Australia.

The chapter argues that the internal fragmentation among the Chinese market actors in China's iron ore import sector and the problems of overcapacity and excessive investment in the Chinese steel industry constituted the two major domestic sources of Chinese vulnerability in the transnational resource politics vis-à-vis Australia.

China's enhanced market status in the iron ore trade failed to bring about an improvement in the Chinese power position vis-à-vis the Australian mining oligarchs. Because of the interest fragmentation and lack of internal coherence among the Chinese market actors in China's iron ore import sector, the Chinese steel industry tried in vain to crackdown on the rampant speculative trading in the iron ore spot market, which contributed significantly to the surging iron ore prices. Given the pluralistic patterns of actors involved and the divergent interests at stake, the Chinese market actors remained rather incapable of maintaining their coherence in the collective struggle against the Australian miners. Notably, the divergent interests among the various state-owned and private market actors of the Chinese steel industry as well as the infighting between the steel industry actors and the minerals trading community clearly demonstrated how internal fragmentation could jeopardise the Chinese efforts to curb the rampant speculative trading and undermine some of the collective bargaining strategies against the Australian mining oligarchs in the price negotiations.

The persistent problems of overcapacity and excess investment in steel capacity considerably increased Chinese demand for iron ore, thereby contributing to the high prices of imported iron ore. Moreover, overcapacity led to over-supply of steel, which was a major cause for the steel industry's persistently bleak outlook over recent years as the Chinese economy slowed down and demand for steel fell. Hence, the problem of overcapacity had simultaneously aggravated Chinese vulnerability to iron ore price hikes and sensitivity to increased raw material costs. The analysis also suggests that the problem of steel overcapacity was reinforced by a series of structural factors pertaining to China's economic growth model and development patterns; problems such as local protectionism and the Chinese economy's heavy reliance on property market and (infrastructure) investment, had all made it extremely difficult to combat overcapacity and eradicate its root causes without paying a huge price.

This chapter finds that the above-mentioned domestic economic constraints had seriously undermined the Chinese efforts to manipulate asymmetrical interdependence and eradicate vulnerability in the iron ore pricing war against the Australian mining oligarchs. By considering the domestic dimension of China's transnational battle with the Australia for iron ore pricing power, the analysis reinforces the thesis' core argument that China has to cope with her vulnerability despite her growing power in the bilateral resource politics vis-à-vis Australia.

**Chapter 6**

This concluding chapter summarises the empirical findings in relation to the theory of complex interdependence, which provides the overarching analytical framework for this study. It seeks to answer the research question by addressing the more specific research objectives that are set out in the introduction chapter.

The chapter argues that China does not enjoy a superior power position vis-à-vis Australia in bilateral resource politics under complex interdependence. Despite the perception of China's rise and the country's favourable power position in terms of the overall power disparities between China and Australia, China nonetheless faces significant international political and domestic constraints in her search for resource security with Australia. In order to protect her resource security interest, China has to navigate cautiously between rising power and vulnerability in her relations with Australia.

## 1.3 Theoretical Framework

### 1.3.1 Neoliberal Theory of Power Politics of Interdependence

The analysis of Chinese-Australian resource politics requires a theoretical understanding of the power politics of interdependence. By combining liberal emphasis on (economic) interdependence and realist focus on power (politics), neoliberal IR theory of asymmetrical interdependence provides a relevant starting point for the analysis of power politics of economic interdependence. Since China's relations with Australia has been characterised by power politics of resource interdependence, it is helpful to begin the analysis by taking a neoliberal perspective on the Sino-Australian resource politics.

The neoliberal theory of interdependence politics is laid out by Keohane and Nye in their seminal work *Power and Interdependence*. It offers a power-oriented analysis of the politics of interdependence, and can be applied to relations between transnational actors (such as multinational corporations) and governments, as well as interstate relations. By and large, the theory itself consists of the following propositions.

First, asymmetrical interdependence can be a source of power. Keohane and Nye suggest that 'a less dependent actor in a relationship often has a significant political resource, because changes in the relationship (which the actor may be able to initiate or threaten) will be less costly to that actor than to its partners' (Keohane & Nye, 2011: 10).

Second, the authors identify two important dimensions of power deriving from asymmetrical interdependence, which are namely 'sensitivity interdependence' and 'vulnerability interdependence'. In terms of the cost of dependence, 'sensitivity means liability to costly effects imposed from outside before policies are altered to try to change the situation', whereas 'vulnerability can be defined as an actor's liability to suffer costs imposed by external events even after policies have been altered' (Keohane & Nye, 2011: 11).

Sensitivity 'involves degrees of responsiveness within a policy framework – how quickly do changes in one country bring costly changes in another, and how great are the costly effects?' (Keohane & Nye, 2011: 10). It is 'measured not merely by the volume of flows across borders but also by the costly effects of changes in transactions on the societies or governments' (Keohane & Nye, 2011: 10). The vulnerability dimension of interdependence 'rests on the relative availability and costliness of the alternatives that various actors face' (Keohane & Nye 2011: 11). It 'can be measured only by the costliness of making effective adjustments to a changed environment over a period of time' (Keohane & Nye, 2011: 11).

Third, *Power and Interdependence* sets out a hierarchy of power resources derived from different types of asymmetrical interdependence (Keohane & Nye, 2011: 13-16). According to Keohane and Nye, power deriving from asymmetrical vulnerability interdependence dominates power deriving from asymmetrical sensitivity interdependence, i.e., 'sensitivity interdependence will be less important than vulnerability interdependence in providing power resources to actors'; 'if one actor can reduce its costs by altering its policy, either domestically or internationally, the sensitivity patterns will not be a good guide to power resources' (Keohane & Nye, 2011: 13). In this regard, 'vulnerability interdependence includes the strategic dimension that sensitivity interdependence omits' (Keohane & Nye, 2011: 14). Keohane and Nye suggest that policymakers and policy analysts 'must examine underlying patterns of vulnerability interdependence when they decide on strategies' since 'coherent policy must be based on an analysis of actual and potential vulnerabilities'; and 'an attempt to manipulate asymmetrical sensitivity interdependence without regard for underlying patterns of vulnerability is likely to fail' (Keohane & Nye, 2011: 14).

Forth, the theory outlines how actors are likely to play the political game between the different levels of power hierarchy. As Keohane and Nye observe, 'a movement from one power resource to a more effective but more costly resource, will be more likely where there is a substantial incongruity between the distribution of power resources on one dimension and those on another'. They suggest that 'in such a situation, the disadvantaged actor's power position would be improved by raising the level at which the controversy is conducted' (Keohane & Nye, 2011: 14). [11]

[11] The authors use the example of the power relationship between a multinational resource company and the foreign host government to illustrate this dynamic. In a concession agreement, a multinational oil company may seem to have a better bargaining position than the host government. The agreement may allow the company to set the level of output, and the price, of the petroleum produced, thus making government revenues a company decision. Yet such a situation is inherently unstable, since the government may be stronger on the vulnerability dimension. Once the

To summarise, ‘influence deriving from favourable asymmetries in sensitivity is very limited when the underlying asymmetries in vulnerability are unfavourable’. This is because ‘if one set of rules puts an actor in a disadvantageous position, that actor will probably try to change those rules if it can do so at a reasonable cost’. Likewise, if a country ‘chafes at its economic vulnerabilities, it may use military force to attempt to redress that situation as Japan did in 1941; or, it may subtly threaten to use force, as did the United States in 1975, when facing the possibility of future oil boycotts’. However, in many contemporary situations, ‘the use of force is so costly, and its threat so difficult to make credible, that a military strategy is an act of desperation’ (Keohane & Nye, 2011: 15).

### 1.3.2 Complex Interdependence Theory

The other major theme in *Power and Interdependence* is the theory of complex interdependence. Keohane and Nye conceive a scenario of world politics that is the opposite of realism. They call it ‘complex interdependence’, which ‘sometimes comes closer to reality than realism does’. Under complex interdependence, world politics would be very different than under realist conditions (Keohane & Nye, 2011: 19).

*Defining Characteristics of Complex Interdependence*

According to Keohane and Nye, there are three defining characteristics of complex interdependence. First, there are multiple channels of contact, which can be summarised as interstate, trans-governmental and transnational relations. Interstate relations are the normal channels assumed by realists; trans-governmental allies emerge when we relax the realist assumption that states act coherently as units; and transnational applies when we relax the assumption that states are the only units. Second, the agenda of interstate relationships consists of multiple issues that are not arranged in a clear or consistent

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country has determined that it can afford to alter the agreement unilaterally, it may have the upper hand. Any attempt by the company to take advantage of its superior position on the sensitivity dimension, without recognising its weakness at the vulnerability level (much less at the level of military force), is then likely to end in disaster (Keohane & Nye, 2011: 14-15).

hierarchy. This absence of hierarchy amongst issues means, amongst other things, that military security concerns do not consistently dominate the agenda. Many issues arise from what used to be considered domestic policy, and the distinction between domestic and foreign issues becomes blurred. The third characteristic is the minor role of military force as state's policy instrument. Military force is not used by governments toward other governments within the region, or on the issues, when complex interdependence prevails (Keohane & Nye, 2011: 20-24).

*'Spectrum Theory' of World Politics: Between the Realist and Complex Interdependence Ideal Types*

Keohane and Nye state that they are not arguing that 'complex interdependence faithfully reflects world political reality' (Keohane & Nye, 2011: 20). Rather, they emphasise that complex interdependence 'can be seen as defining an extreme set of conditions or ideal type' (Keohane & Nye, 2011: 19). What they are suggesting is a 'spectrum theory' of world politics, in which both complex interdependence and 'realist portrait are ideal types', and 'most situations will fall somewhere between these two extremes' (Keohane & Nye, 2011: 20). They argue that 'sometimes, realist assumptions will be accurate, or largely accurate, but frequently complex interdependence will provide a better portrayal of reality' (Keohane & Nye, 2011: 20). They caution their readers that 'before one decides what explanatory model to apply to a situation or problem, one will need to understand the degree to which realist or complex interdependence assumptions correspond to the situation' (Keohane & Nye, 2011: 20).

*Linkage Process under Complex Interdependence: Distinction between Structure Model and Issue Structure Model*

From the perspective of traditional (realist) analysis, military security will be the dominant goal of states' in the realist world; military security will even affect issues that are not directly involved with military power or territorial defence; and non-military problems will not only be subordinated to military ones, but also be studied for their politico-military implications. As a result, militarily and economically strong states will dominate a variety of organisations and on a variety of issues, by linking their own policies on some issues to other states' policies on other issues; by using their overall dominance to prevail on their weak issues, the strongest states will, in the realist world, ensure a congruence between the overall structure of military and economic power and the pattern of outcomes on any one issue area. Hence, under realist conditions, the overall power relationship matters because it determines the outcome of the specific issue through the linkage process; and Keohane and Nye call this the ‘overall power structure’ model for the analysis of power politics of interdependence (Keohane & Nye, 2011: 35-39).

Keohane and Nye argue that such congruence is less likely to occur under complex interdependence. This is because as military force is devalued, militarily strong states will find it more difficult to use their overall dominance to control outcomes on issues in which they are weak. As a result of this, ‘strong states will find that linkage is less effective’ (Keohane & Nye, 2011: 25). Hence, under complex interdependence, the issue-specific power relationship matters more than the overall power relationship in determining the outcome of the specific issue. Keohane and Nye call this the ‘issue structure’ model for the analysis of power politics of interdependence (Keohane & Nye, 2011: 42-44).

In short, under realist conditions, linkages will reduce differences in outcomes amongst issue areas; and the overall power structure model is more applicable for the analysis of power politics. Under complex interdependence, linkages by strong states will be more difficult to make; and the issue-specific power structure model becomes a more powerful and relevant model to explain the outcome of power politics on a particular issue area. As Keohane and Nye observe, ‘as the utility of force declines, and as issues become more equal in importance, the distribution of power within each issue will become more important’ (Keohane & Nye, 2011: 25-26).

*Agenda Politics under Complex Interdependence*

Under complex interdependence, the so-called ‘high politics’ no longer dominate, and agenda politic becomes more important and complicated with respect to agenda formation and control. Keohane and Nye observe that under complex interdependence, state agenda is no longer primarily influenced by shifts in the overall balance of power between states or perceived military security threats; instead, it is expected to be heavily influenced by a wide range of sources. For instance, agendas can be affected by politicisation of international and domestic problems created by economic growth. Pressure for agenda change can come from the parties impatient with an ineffective international regime that no longer delivers outcomes consistent with underlying power structure. Change of agenda can be a result of rising sensitivity interdependence, or due to discontented domestic groups seeking politicisation of issues and state intervention. It can also be a product of shifts in the distribution of power resources within issue areas, or a consequence of policy shift by a dissatisfied government with growing strength.

Given the growing salience of non-military affairs and the increasing complexity of actors and links between countries under complex interdependence, states no longer act as monolithic entities with a unified and coherent view of their own national interests. This pluralisation process, characterised by growing ambiguity and competing interpretations of the national interest, will complicate agenda politics as suggested above, and renders the goals of the state increasingly difficult to define. Under complex interdependence, different state actors are expected to pursue different interests. For instance, various government agencies will pursue their own organisational interests under the guise of national interests. Transnational actors such as multinational corporations will also pursue their own goals. As the conditions of complex interdependence are more closely approximated, the processes of agenda formation and goal setting will become more subtle and differentiated (Keohane & Nye, 2011: 26-28).

*Power Politics of Asymmetrical Interdependence under Pluralisation and Fragmentation*

Given the negligible role of force and the military security agenda, states will rely more on other instruments in order to wield power; and less vulnerable states will try to use asymmetrical interdependence in particular groups of issues as a source of power. Power resources derived from asymmetrical (sensitivity or vulnerability) interdependence specific to issue areas will be the most relevant and effective instrument. Hence, manipulation of asymmetrical interdependence becomes major instruments of state policy.

According to Keohane and Nye, the more closely a situation resembles complex interdependence, the more we can expect the outcomes of political bargaining to be affected by fragmentation. Internal fragmentation in terms of pluralisation of interests and actors will undermine the state's ability to manipulate asymmetrical interdependence. *Power and Interdependence* suggests that 'states that are better placed to maintain their coherence will be better able to manipulate uneven interdependence than fragmented states that at first glance seem to have more resources in an issue area' (Keohane & Nye, 2011: 29).

Under complex interdependence, transnational actors pursue their own goals as independent actors whilst being used as policy instruments manipulated by governments; and there is 'less assurance that fragmented state will be united when dealing with foreign governments or its components will interpret national interests similarly when negotiating with foreigners'. The fragmented state may therefore 'prove multi-faceted, even schizophrenic' (Keohane & Nye, 2011: 29).

Moreover, internal incoherence and fragmentation make it more difficult for the economically dominant power to follow a consistent strategy of economic linkage. This is because domestic, transnational and trans-governmental actors might resist having their interests traded off and different issues may involve different actors, and the international organisations in which negotiations take place are often quite separate; as a result, these factors might all make a trade-off or concessions linkage difficult to achieve in practice (Keohane & Nye, 2011: 28-29).

### 1.3.3 Theoretical Relevance

China's relations with Australia primarily reflect the condition of extensive economic interdependence. The situation characteristically represents complex interdependence as seen from the vital importance of resource agendas, the multiple channels of contact between the two countries, and the minor role of military force as policy instrument. The inherent strategic tensions in the bilateral relations as outlined in the introductory section represents the existence of realist dynamics; but the realist dynamics do not dominate China's relations with Australia. Insofar as the position on the continuum between the ideal types of complex interdependence and realism is concerned, this predominance of complex interdependence suggests a position siutated closer to complex interdependence.

The position on the spectrum suggests that China's resource power politics with Australia has to be understood largely in the context of complex interdependence. The implication is that analysis of power politics over the specific issues of iron ore pricing and Chinese resource investment has to be considered with respect to the issue-specific power structure model rather than the overall power structure between the two countries. This is because under complex interdependence, military force is devalued and traditional military security agenda no longer dominates policy agenda; as a result, the linkage mechanism is likely to breaks down; thus, the issue-specific outcomes depend on the issue-specific power structure.

Since power deriving from asymmetrical sensitivity and vulnerability interdependence is more relevant under complex interdependence, the analysis of power politics of iron ore pricing and Chinese resource investment has to look at the issue-specific patterns of asymmetrical interdependence in relation to sensitivity and vulnerability. Given the hierarchy of the power resources deriving from asymmetrical interdependence, it is all the more important to examine the underlying patterns of asymmetrical vulnerability interdependence, which is likely to determine the outcomes of the power struggle in those two issue areas. As this thesis will show, the Chinese side is faced with unfavourable patterns of asymmetrical interdependence in each of the two issue areas; the Chinese market actors from the steel industry fail to gain the upper hand in the battle for iron ore pricing power against the dominant Australian mining oligarchs, and Chinese government investors have little leeway in the face of the Australian government's efforts to block and restrict Chinese government investment in Australia's resources sector.

From the perspective of agenda politics, the iron ore pricing issue has become a matter of national economic security because the Chinese steel industry's growing sensitivity to rising iron ore costs has led to politicisation of the iron ore pricing issue in China; as China's market size continues to increase in the global iron ore trade, the Chinese have become increasingly intolerant to their lack of pricing influence and the unfavourable terms of trade in the iron ore business. To a large extent, China's aggressive investment and acquisition spree into Australia's resources sector represents an attempt to reduce over-dependence on the Australian mining oligarchs for ore supplies, which is said to have considerably contributed to Chinese vulnerability in the iron ore pricing war. In short, agenda formation is no longer dominated by traditional state-centric military security concerns; insofar as China's resource power politics with Australia is concerned, agenda is primarily shaped by economic processes and the evolving interests of multiple actors involved in resource politics. Nonetheless, behind the transnational face of those power struggles, the interests of those sub-state actors to a large extent still represent the interests of the state.

Under complex interdependence, internal fragmentation among actors can undermine the coherence of state strategy. This has been observed in the collective Chinese efforts to boycott iron ore imports from the Australian mining oligarchs and to crack down on the rampant speculative trading on China's iron ore spot market. As the subsequent analysis in Chapter 5 will demonstrate, the multiplicity of actors involved and the divergent interests between the various market actors in China's iron ore import sector have rendered any unified Chinese actions led by industry leaders extremely difficult to sustain in practice. Domestic incoherence has essentially neutralised the major Chinese manoeuvres during the iron ore price negotiations and undermined efforts to tackle the entrenched vulnerability in the iron ore pricing struggle.

As stated in the introductory section of this chapter, the analysis of the bilateral resource power politics has to take account of the dynamic security relationship between China and Australia. Indeed, from the 'spectrum' perspective, this is a sensible approach because the specific position of any situation of world politics along that continuum has analytical and real-world implications. In the context of this study, though realist dynamics do not dominate the bilateral relations, the resource ties nonetheless are grown out of such a delicate geopolitical framework. As the subsequent chapters will show, the inherent tensions in the strategic dimension of the bilateral relations have a constraining effect on the development of the resource partnership. In other words, China can hardly expect to forge a genuinely reliable, deep and equitable resource partnership with Australia, which in many respects is a potential strategic adversary in the light of the deteriorating regional strategic environment. Indeed, as the analysis of the controversies over iron ore pricing and Chinese government investment will demonstrate, the resource partnership is by no means an easy pair. The uncertainties of the bilateral geopolitical ties arguably have posed huge strategic constraints and risks for China's resource security interest.

### 1.3.4 Complex Interdependence Theory: A Critique

*Inadequate Theorisation of the 'Spectrum' Perspective*

Keohane and Nye conceive a 'spectrum' of world politics between the two ideal types of complex interdependence and realism. They suggest that the location of a particular situation on the spectrum determines the applicability of the theoretical model for analysis. However, despite the significance they give to a particular position on the spectrum, their theoretical approach fails to specify the exact analytical and real world implications of what the position entails; much is left unexplained as to how positions 'in-between' the ideal types along the continuum might manifest in real world political situations under analysis. This can be problematic for analysis because, as Keohane and Nye suggest, most real world situations will fall somewhere in between the two extremes along the continuum of complex interdependence and realism. Indeed, this particular theoretical inadequacy could, to some extent, undermine the validity of complex interdependence theory. As Keohane and Nye themselves admit, '… precisely because we insisted that complex interdependence is an ideal type rather than an accurate description of world politics or a forecast of trends, its relevance to contemporary world politics is ambiguous' (Keohane & Nye, 2011: 269) Although they emphasise that the 'position of a given situation along this continuum constitutes the independent variable…', they go on to say that the relationship between this independent variable and what complex interdependence theory seeks to explain 'was somewhat muddle[d]' (Keohane & Nye, 2011: 269).

This limitation of the 'spectrum' perspective is evident in the analysis of China's resource politics with Australia. First of foremost, the broader geopolitical environment dictates that there will always be inherent strategic tensions in the bilateral relations; the growing adversarial dynamics observed in recent years reflect increasing salience of realist agenda; and to some extent transnational resource politics is carried out in the context of inter-state rivalry for resource power, not least because most of the transnational market actors involved were agents of the state, particularly on the Chinese side. Despite the seeming predominance of complex interdependence, this theory does not provide analysts with a clear explanation insofar as the mutual interactions between complex interdependence and realist dynamics, as well as their implications, are concerned. Whilst this thesis does identify one the constraining influence of the adversarial realist dynamics on the scope and nature of the bilateral resource investment and trade relationships, the exact patterns of interactions between those geopolitical elements and economic affairs, requires a more sophisticated and elaborate theoretical discussion on the analytical and practical implications of the location along the spectrum. Arguably, the same can be said about the relationship between the ongoing prolonged Free Trade Agreement process and the evolving geopolitical orientation of the bilateral relations between China and Australia.

The potential theoretical implications of the spectrum position are highly relevant to understanding China's international relations, whereby forces of economic globalisation have increasingly come to mingle with the realist dynamics triggered off by shifts in power. Indeed, a coexistence of the realist and complex interdependence dynamics, whereby manifestations of realism and complex interdependence emerge simultaneously and intermingle, would suggest an 'in-between' position on the theoretical spectrum. Although, the exact position along the continuum depends on the relative significance of realist and complex interdependence dynamics in reality during a specific period of time. This complexity of realities is somewhat at odds with the theoretical emphasis on the ideal-type assumptions and makes analysis of real world politics difficult. Yet complex interdependence theory fails to significantly elaborate on how world politics looks like under such circumstances. This might raise questions about the theory's actual applicability to the study of contemporary Chinese foreign relations.

Arguably, the inherent inadequacy of the 'spectrum' perspective has its roots in the Cold World era, when world politics was much more polarised between two opposing camps. When the theory was first conceived and developed during the Cold War, the condition of complex interdependence was more frequently observed in the international relations between the Western allied industrialised democracies, whereas the traditionalist visions of typical realist dynamics were more applicable to the international relations between countries in opposing ideological camps between the East and the West. In that scenario, trade, investment and finance did not flow freely between the opposing camps. The distinction between the condition of complex interdependence and realism were much more clear-cut; and the position of any particular political situation on the spectrum appeared to be relatively easier to locate and pinpoint.

Today, a mixture of liberal and realist dynamics in international relations is a much more common phenomenon. Whilst forces of economic globalisation still prevail, the competitive dynamics of realism have increasingly appeared in situations where liberal logic once dominated. In particular, China's rise, which is essentially a phenomenon facilitated through economic globalisation, has begun to intensify realist dynamics by bringing about systemic changes in the global power structure. The power transition driven by China's continued rise has increasingly destabilised the strategic status quo and encouraged adversarial strategic dynamics to occur, in which realist dynamics necessarily interact with and complicate the elements of complex interdependence under the condition of extensive economic interdependence. Insofar as China's foreign relations are concerned, complex interdependence theory needs to address this complexity by developing a more explicit exposition and argument about the theoretical implications of the 'in-between' position along the continuum. Some such pertinent questions that should be addressed include: How exactly does occupying a different position on the spectrum shape the manifestation of international politics? How can one determine the exact position on the spectrum? Moreover, how can one assess the relative extent of liberal and realist dynamics in a particular political situation? How quickly can a country's position along the spectrum shift and what will such a shift mean in policy terms? In essence, these questions concern the relative importance and interplay of realist and liberal forces, and how they would shape international relations.

*Incompleteness of the Economic Linkage Argument*

The theory of linkage is inadequately developed in *Power and Interdependence*. In this book, Keohane and Nye argue that under complex interdependence, the linkage process is likely to break down: since military force is too costly and a traditional military security agenda no longer dominates the foreign policy agenda, the militarily powerful state will find it more difficult to use their overall (military) dominance to control outcomes on issues in which they are weak (Keohane & Nye, 2011: 25-26). Given the collapse of the linkage mechanism, the issue-specific power structure is more relevant than the overall power structure to political analysis of a particular issue area under complex interdependence (Keohane & Nye, 2011: 42-44).

However, this narrow emphasis on 'issue compartmentalisation' approach to the linkage process under complex interdependence can be problematic. As Arthur Stein points out, 'linkage is the central analytic problem with an issue approach to international politics. Issue compartmentalisation only goes so far… Because there are situations amenable to linkage politics, the viability of an issue-area approach to the study of international politics is itself context-dependent' (Stein, 1980). Even Keohane and Nye admit that they 'failed to develop any theory of linkage that could specify under what conditions linkages would occur' despite the importance of the subject. They acknowledge that 'the lack of extensive analysis of issue linkage in *Power and Interdependence* must have struck some observant readers as one of the oddest aspects' of their work (Keohane & Nye, 2011: 268).

In particular, Keohane and Nye fail to develop a coherent argument about the linkage process under complex interdependence with respect to how economically powerful states can use their overall economic predominance to secure favourable outcomes in a particular economic issue area. After all, many issue linkages take place between different economic affairs in international relations; in other words, linkage is a phenomenon between different economic issue areas as much as between economic and security issue areas. At the core of the issue is the 'fungibility' of economic power - whether states can translate their overall economic power dominance into issue-specific power advantage by transferring economic power across different economic issues (since linkages amongst issues invariably involve making concessions on one issue for securing gains on another issue). However, the theoretical discussion of the 'fungibility' of economic power is somewhat muddled, particularly under complex interdependence.

When discussing the linkage process, Keohane and Nye suggest that 'dominant states may try to secure much the same result by using overall economic power to affect results on other issues'… since 'money, after all, is fungible'. Although they do not specify under what condition (whether realism or complex interdependence) money is fungible, they do emphasise that 'if only economic objectives are at stake, they may succeed' (Keohane & Nye, 2011: 25-26). Yet, they also seem to suggest that under complex interdependence money is not after all that fungible, because 'economic linkage by the strong is limited by domestic, transnational, and trans-governmental actors who resist having their interests traded off', and 'economic objectives' can 'have political implications' that might forestall economic linkage. They also suggest that the different international actors involved in different issues could also work against linkage across economic issues (Keohane & Nye, 2011: 26, 28-29).

When discussing the issue structure model 'in which force is usable only at high cost, and military security is not at the top of a clear hierarchy of issues for governments', Keohane and Nye state that 'economic capabilities relevant to one area may not be relevant to another' when the issue structure model is more applicable. However, their explanation (devalued military force and absence of a hierarchy of issues) seems to be more relevant to the conclusion that 'military capabilities will not be effective in economic issues' under such a model (Keohane & Nye, 2011: 42). In short, Keohane's and Nye's explanation of the 'fungibility' (or 'infungibility') of economic power is ambiguous, as is their discussion on how powerful states might exploit their overall economic predominance (as opposed to military dominance) vis-à-vis weaker states to secure favourable outcomes in a specific economic issue.

The incompleteness of their treatment of transferability of economic power resources (especially under complex interdependence) is not helpful when analysing certain aspects of the Sino-Australian resource politics, where economic linkages are thought to be actively pursued by the Chinese and Australian actors involved. The prolonged free trade agreement (FTA) negotiation has been a case in point. The Chinese government has reportedly pushed for greater investment access for Chinese capital (private and government-related investment) and the loosening of labour restrictions on foreign workers; whereas the Australian side has demanded greater access to the Chinese domestic market for Australian agricultural exports and service-sector businesses.[12] In essence, this process of FTA negotiation represents a grand bargain between China and Australia whereby economic linkages take place across multiple economic issue areas. Arguably, the Chinese government is trying to use her overall economic power advantage in terms of China's market size to induce Australian concessions on the specific issues pertaining to access for Chinese government investment. In this regard, a more sophisticated theoretical treatment of economic linkage would be extremely useful for analysing the Chinese policy deliberations, which are essentially part of the ongoing Chinese efforts to tackle their vulnerability in the controversy around Chinese government investment in Australia's resources sector. In this context, it does not make much sense to rule out the viability of economic linkage under complex interdependence altogether.

*Theoretical Neglect of the Domestic Perspective*

The third major weakness of complex interdependence theory is its lack of thorough treatment of the domestic factors. Keohane and Nye state that they have deliberately limited their analysis to the level of international systems in the interest of theoretical parsimony, which 'is so highly valued by students of

[12] Source: '20th Round of China-Australia FTA Negotiation to Be Held in Canberra in May' (April 3, 2014) http://jingji.21cbh.com/2014/4-3/zNMDA2NTNfMTEyMDIzNA.html

international relations' (Keohane & Nye, 2011: 271-272). Although they recognise the importance of processes at the domestic level, the priority of theorisation is 'first to sort out the systemic forces at work' (Keohane & Nye, 2011: 271). However, this systemic approach neglects the crucial domestic sources of international politics. As Keohane and Nye themselves admit, analysts 'had to view interests as formed largely exogenously', and 'domestic politics and the impact of international relations on domestic politics…were ignored' (Keohane & Nye, 2011: 271). Indeed, the result of such an approach is a self-imposed analytical barrier that tends to discourage a more in-depth analysis of the important domestic political and economic processes under complex interdependence; and this exclusive focus on systemic perspective weakens the prospects for a deeper understanding of important dynamics under complex interdependence, such as agenda politics and linkage politics.

As the study of Chinese-Australian resource politics demonstrates, the analysis of domestic economic and political processes is critical for understanding the sources of Chinese sensitivity and vulnerability in the struggle over iron ore pricing power and the controversy around Chinese investment in Australia. In particular, the domestic perspective is essential for understanding how the relevant resource security agenda took shape within China in response to the country's growing sensitivity and vulnerability; and it would be impossible to understand Chinese vulnerability in the iron ore pricing war without looking into how internal interest fragmentation amongst the Chinese market actors, as well as economic constraints facing the Chinese steel industry, contributed to China's predicament. Although complex interdependence theory provides a number of insights into some of the domestic-related considerations – such as fragmentation amongst actors, incoherence of national interests and the pluralist face of states under complex interdependence – the discussion is nonetheless limited and constrained to an analysis of the implications of transnational and trans-governmental relations. It does not facilitate a serious theorisation of the relationship between domestic factors and international politics under complex interdependence. In fact, as the multiple channels of contact have further blurred the boundary between what is domestic and what is systemic, the domestic dimension indeed deserves more serious treatment in complex interdependence theory.

## 1.4 Literature Review

This section mainly surveys the existing academic literature on China-Australia relations.

### 1.4.1 Chinese Language Sources

To trace the sources of Chinese foreign policy towards Australia, a survey of relevant works in the Chinese language is a necessary first step. For Chinese scholars, whether in the field of foreign policy or from other academic fields, the South Pacific region is a relatively neglected area compared with China's immediate neighbouring regions. Despite being the largest country in the South Pacific, Australia has not historically received strong research attention from Chinese scholars (Jia & Hou, 1999).

Australian studies is a relatively underdeveloped academic field at Chinese universities; research on Australia lags far behind the United States and Britain, despite being China's nearest English speaking country (Cai et al., 2002). Book-length Chinese writing on Australian foreign affairs and related subjects are rare in the literature on Australia, the majority of which being studies of Australian culture, literature and language. Given the poor state of Australian studies in China, it comes as no surprise that Chinese academic research on Sino-Australian relations has been rather weak (Wang, 2003).

Nevertheless, a few book-length works on the bilateral relations have appeared since the early 1990s. The first book was an edited volume on Sino-Australian economic cooperation by Wang & Duan (1991), which was followed by a translation of E.M. Andrews' *Australia and China: the Ambiguous Relationship* (Gao et al. trans., 1992; Andrews, 1986). Hou Minyue's *History of Chinese-Australian Relations* (1999), Hu Zhuanglin's *A Bright Prospect of Sino-Australian Cooperation* (2000), and Wei Songshou's *Australian Economy and Foreign Trade in Transition: the Progress of Australia's Relations with China* (2001), were three welcome contributions to the literature at the turn of the century. Hou Minyue's *The Impact of China's Modernisation on Relations with Australia* (2005a) is a more recent addition to the list. Indeed, it is the most up-to-date (at least at the time of its publication), comprehensive and in-depth study of the development of the bilateral relations between the two nations since China's reform period began. Hou examines the economic, political, security/strategic, and multilateral (both regional and global) aspects of the bilateral relations, and China's policy in each of the four domains. In light of the fact that it is all too common for scholars to write how Australia perceives and treats China, what is perhaps the most valuable feature that distinguishes this work from the rest is that Hou has made a special effort to systematically look into China's policy towards Australia, as opposed to the other way round. One edited volumes of research articles on Chinese-Australian ties was published in 2012 to mark the 40th anniversary of the establishment of the diplomatic relationship between the People's Republic of China (P.R.C.) and Australia. It is co-edited by Chinese scholars Chang Chenguang and Yu Changsen (Chang & Yu 2012).

Although most of the Chinese academic research articles on Sino-Australian relations have appeared fairly recently over the last ten years, they have not adequately covered the more recent developments in the bilateral relations. One notable exception is Gao Cheng's works, which survey the recent developments in Chinese-Australian relations in 2011 and 2012 by looking at the basic trends in the bilateral ties, and the impact of enhanced allied cooperation between Australia and the United States on Chinese-Australian relations. (Gao, 2012; Gao, 2013) Many of them have been exclusively concerned with issues in the pre-1980s period, such as the establishment of Chinese consulates in Australia in the late Qing Dynasty (Zhang, 1994), Australia's China policy from the late 1940s to the early 1970s (Wu, 2006) and during the Vietnam War (Hou, 2002), as well as the establishment of diplomatic relations between the P.R.C. and Australia (Wu, 2006; Wang, 2003a; Zhang, 2002a; Zhang & Wang, 1999). The 1990s has been lightly touched on in some works (Chen, 1993; Jia & Hou, 1999; Wang, 2004; Nie, 2003a, 2003b), while exclusive treatment of the bilateral ties during the Howard years was undertaken in only four articles (Yang, 2005; Zhang & Huang, 2007; Zhang & Zhou, 2007; Hou, 2007).

It is fairly evident that more substantial analysis of Chinese policy towards Australia is lacking in these works. Zhang (1994) addresses the Qing Dynasty's decision to set up its consulates in Australia. Zhang and Huang (2007) discuss contemporary Chinese perceptions of Australia's strategic importance. These are the two exceptions that approach the bilateral relations entirely from the Chinese perspective. Many other works are exclusively analyses of Australia's policy towards China (Hou, 2002; Zhang, 2002a; Nie, 2003a; Yang, 2005; Wu, 2006; Zhang & Zhou, 2007) The rest contain only passing reference to China's policy (Jia & Hou, 1999; Zhang & Wang, 1999; Wang, 2003a, 2004; Hou, 2005b, 2007). For example, Wang (2003a) briefly mentions China's use of 'wheat trade diplomacy' in an attempt to influence

Australia’s recognition policy as well as Chinese positions on the issues of Taiwan and China’s representation in the United Nations (U.N.) before the establishment of diplomatic relations. There is also a short mention in Zhang and Wang’s (1999) and Jia and Hou’ (1999) works on Australia as a country of the Second World to be united in the struggle against superpower hegemony in Mao’s ‘Three Worlds’ theory. Hou (2005d) talks briefly about China’s policy towards Australia on the Cambodia issue. Chinese attitudes towards Australia’s American alliance, especially in relation to Australia’s role in the Taiwan issue, is touched upon by Jia and Hou (1999), Hou (2007) and Zhang and Huang (2007). China’s economic diplomacy is mentioned in only a few sentences by Hou (2007).

Writings on the economic relationship have appeared since the mid-1980s. Amongst these works, only three books have been written on the subject (Wang & Duan, 1991; Yu, 1998; Duan, 2000), while the rest have been journal articles, many of which have been professional accounts of trade business. More academic analyses of the bilateral economic relations have emerged over the last ten years. However, they have generally focused on analyses economic technicalities, and have neglected to bring foreign policy considerations into the discussion. No efforts have been made to specifically discuss the political context or strategic implications of the economic ties.

A great majority of the academic works focus on the merchandise trade, and recent studies have looked at the question of bilateral Free Trade Agreement (Zhu, 2005; Yang et al., 2005; Qin & Wang, 2006; Sun, 2007; Zhang, 2007). Resource trade has received some attention in more recent years, yet only one article has exclusively addressed trade in mineral resources (Huang & Li, 2006). While many writers acknowledge that Australia is one of the few popular destinations for China’s overseas investment, no specific research has been carried out to investigate the influx of Chinese capital into Australia’s resources sector.

The bilateral resources ties have received some research attention in more recent years especially after 2008. Gao Cheng’s structural analysis of the asymmetrical interdependence in Sino-Australian trade relations also explores the sensitivity and vulnerability dimensions of the economic ties, especially in relation to the bilateral iron ore trade. Gao concludes that, while both countries are highly sensitive to the mutual interdependence in the iron ore business, China is the relatively more vulnerable party in her iron ore trade with Australia (Gao, 2008). In an overview of the Chinese-Australian iron ore trade and investment relations, Hou Minyue offers a brief review of the history of the bilateral iron ore ties, and highlights the pattern of Chinese sensitivity and vulnerability in the bilateral iron ore trade. Hou's study not only examines the asymmetrical interdependence in the iron ore trade, but also accounts for the growing Chinese investment interest in Australia by linking the iron ore trade issue with the Chinese investment issue. His analysis of the strategic significance of the Chinalco-Rio Tinto deal and the important lessons drawn from its failure is informative (Hou, 2010).

### 1.4.2 English Language Sources

English sources on P.R.C.-Australia relations have mostly been written by Australian scholars. Ten volumes have appeared since the 1960s on the subject (Albinski, 1964a; Albinski, 1965; FitzGerald, 1972; Dunn & Fung, 1985; Fung & Mackerras, 1985; Andrews, 1986; Mackerras, 1996a; Fung & Chen, 1996; Strahan, 1996; Thomas, 2004). Amongst them, three are multi-authored edited volumes. One edited volume on China-Australia ties has also appeared in 2012 to mark the 40$^{th}$ anniversary of the establishment of the diplomatic relationship between the P.R.C. and Australia. (Reilly & Yuan 2012) Another notable recent addition to this literature has been David Uren's work. As economics editor of *The Australian*, Uren's gives an interesting and informative account of Australia-China relations interspersed with entertaining stories from a journalistic perspective.

Books that appeared prior to the 1990s are most useful for understanding the historical evolution of Australia-P.R.C. relations before the end of the Cold War. Albinski offers the first historical account of the early relationship between Communist China and Australia during the Korean War (1964b). He also surveys the security, trade and immigration issues between the two countries in the 1950s and the first half of the 1960s (1965). FitzGerald recalls the Australian Labour Party's historic visit to China in 1972 and offers his sober analysis of China's foreign policy in the early 1970s (1972). The detailed historical analysis contained in the work of Fung and Mackerras (1985) is the best source for understanding how the relationship was transformed from fear and xenophobic hostility into a stable friendship.

Strahan (1996) offers a systematic full-length study of Australia's changing perceptions of China over an extended period from the Sino-Japanese War to the early 1990s, rejecting the 'pendulum model' in explaining Western perceptions of China. Each of the two edited volumes (Mackerras, 1996a; Thomas, 2004) provide comprehensive coverage of every aspect of the partnership between China and Australia in the early 1990s and the early 2000s, respectively. Thomas' work is the latest entry, and remains the only book published since the mid-1990s on the subject.

In addition to book-length works, studies of the bilateral relations have also appeared in academic journal articles. Most of them have been published in the *Australian Journal of International Affairs*, the A*ustralian Journal of Chinese Affairs* and the *Australian Journal of Politics and History*. Journal articles on P.R.C.-Australia relations were rare before the 1980s, but have steadily increased since the 1980s as the bilateral relations developed and matured. In the last two decades up until 2007, there have been at least 14 such journal articles, a sign of burgeoning research interest in the field.

During that same period a large number of edited volumes appeared that offered comprehensive surveys of Australian foreign policy or Australia-Asia relations. China was an indispensable component in those discussions, and always warranted separate treatment covering a single chapter in those volumes. Hence, the 1990s witnessed a surge in book chapters on Chinese-Australian relations. Since the 1990s, at least 17 such book chapters on Australia's ties with China have been produced.

These articles and book chapters on Sino-Australian relations are an abundant source of information for writing a literature review. Given the limited scope available here, it is not feasible to engage in a comprehensive survey of the entire literature in great depth. Indeed, I can state with reasonable confidence, that it is not necessary for the purpose of this thesis. Nevertheless, some deficiencies in this body of scholarship are worth commenting in order to help shed light on the areas that deserve more research attention.

One obvious weakness is the lack of thorough investigations into China's foreign policy approach towards Australia. As the first Australian ambassador to China, FitzGerald was one of the few writers who displayed a serious interest in China's foreign policy. His personal impressions of Chinese diplomacy in the early 1970s constitute the earliest account of China's Australia policy (1971; 1972; 1973). Shi Chunlai

(2002) offers a valuable source for understanding China's basic attitudes towards Australia. In his contribution to the *Australian Journal of International Affairs'* special edition marking the 30th anniversary of the establishment of diplomatic relations, the former Chinese ambassador to Australia expresses China's wish for an independent and pragmatic Australian foreign policy free of U.S. influence and ideological bias. He goes on to highlight the Taiwan issue and American containment of China as the two major strategic issues that affect Sino-Australian relations. In another article penned by a learned student of Chinese-Australian relations, Hou Minyue (2005) explains why the so-called Howard Doctrine has been an irritant to China. Despite these exceptions, the body of literature mostly focuses on Australia's foreign policy towards China or how Australians perceive the bilateral ties.

Scholars (Fung & Mackerras, 1985; Fung, 1986; Mackerras, 2004) have suggested that the Sino-Australian partnership is an unequal relationship: the vast disparities in power, international influence and status between China and Australia mean that China is always more important to Australia than Australia is to China. In the eyes of the Australians, China will always be one of the most important countries for Australia's prosperity and security, whether in a positive or negative way. By contrast, as a regional middle power at best, Australia has traditionally occupied only a peripheral place in China's worldview and foreign affairs. This disparity reflects critical differences in the two countries' centre of strategic gravity and orientation.

A corollary of this conventional wisdom is the common perception that China is in some senses indifferent to Australia, and China can afford not to have a proactive and strategic approach to its Australia policy. China's many policy responses towards Australia have, at best, been *ad hoc* and reactive. To put it plainly, China's approach prompts the question: does China have an Australia policy? This question of how China treats Australia is exactly what has been described in those works that have occasionally touched upon China's Australia policy.

For instance, according to some writers (FitzGerald, 1971; Fung & Mackerras, 1985), Australia's formal recognition of the People's Republic was highly desired by the Chinese because it would serve China's interest in raising the country's international status and breaking out of international isolation in the precarious years of the early 1970s; but it was never a great prize that China would have desperately pursued or actively sought, a policy which was manifest in Chinese diplomacy throughout the game of political manoeuvres over the establishment of diplomatic relations before 1972.

The fact that Australia was once a second-rate strategic partner of China against Soviet expansionism did not help change Australia's marginal position in Chinese strategic thinking during the 1970s and 1980s. It merely helped the two countries to maintain a reasonably amicable relationship, which in reality lacked substantive content and was dwarfed by China's preoccupation with great power relations. The Kampuchea/Cambodia problem was the only substantive political issue over which China occasionally consulted Australia during this period. As the bilateral relationship was often a function of a third-party factor, Australia's importance to China was more auxiliary than independent until bilateral trade grew to the level where it became the real binding force that could pull the two countries together on a firm basis.

The literature on current Sino-Australian relations gives the impression that China does not seem to have a proactive Australia policy except for the general objective to increase trade. However, this is a policy objective that applies to China's relations with every other country and tells little concerning what China actually wants from Australia, apart from a general desire to further economic cooperation. This literature does seek to address a range of bilateral issues that have emerged since the 1990s, such as those concerning Taiwan, human rights, Tibet, Australia's American alliance, and its strategic relationship with Japan, etc. However, the passing mentions made to China's sporadic responses to Australia's policy on these issues, in no measure amounts to a systematic account of Chinese strategic intentions towards Australia and the specific policies that China has pursued to achieve these objectives.

A growing research interest in Chinese-Australian relations emerged towards the end of the 2000s against the background of China's rise. These works are mainly concerned with the analysis of Australia's strategic and diplomatic responses to a rising China. Interestingly, the politics of accommodation in the face of China's rise is a major theme that underlies much of this discussion.

James Manicom and Andrew O'Neil examine the extent to which Australia' has accommodated China's policy preferences across the three issue areas pertaining to bilateral economic relations, war and peace, and soft power during the 2000s (Manicom & O'Neil, 2010). The two authors also compare Australia's response to China's rise with that of Canada and explain some of the notable differences in their respective policy approaches as two resource-rich Western middle powers of the Asia-Pacific (Manicom & O'Neil, 2012). He Baogang's work uses the Australian case to illustrate the politics of accommodation in the context of changing power relationships and to explain the regional secondary states' accommodation policy towards a rising China (He, 2012c).

Czeslaw Tubilewicz's research discusses Australia's recent strategic response to China's by focusing on Australia's 2009 Defence White Paper and examines Chinese responses to the White Paper (Tubilewicz, 2010). James Reilly seeks to account for Australia's strategic response to China by highlighting the relationship between deepening economic interdependence between the two countries and Australia's strategic behaviour towards China.

Zhang Jian's survey of the 'most revealing' five-year period in Australia's relations with China between 2006 and 2011 reviews the Rudd's government's policy initiatives and the major political and economic hurdles that has emerged in the bilateral ties under the Labour government since 2007 (Zhang, 2012).

You Ji's work analyses the military dimension of Chinese-Australian relations in the context of the potential strategic impact of the People's Liberation Army's transformation on Chinese-Australian strategic relationship (Ji, 2013). Former Australian Ambassador Geoff Raby's policy review highlights the importance and nature of Australia's critical relationship with China and sets out several recommendations on how to improve Australia's policy approach to the indispensible ties with China (Raby, 2013).

The significance of China's economic rise for Australia's economic prosperity and foreign policy is recognised by more recent works on the bilateral relations. The pre-2008 literature asserted that growing bilateral trade has become the basis and the stabiliser of Chinese-Australian relations; and that the natural complementarities between the two economies would ensure smooth development of the economic relationship. These simple assumptions however neglected the potential for conflict. The economic ties are currently undergoing significant transformations that are capable of creating conflicts in the economic relationship. There is only one notable exception that has looked into the conflict side of the economic ties in an article focusing on the politics of Free Trade Agreement between China and Australia (English et al., 2005). Yet, the full implications of China's domestic economic processes on bilateral relations have not been fully appreciated. The impact of China's growing economic ambitions, domestic economic incentives and constraints on the bilateral ties and China's Australia policy needs to be the focus of more research.

More recently, there has been a growing research interest in the bilateral resource relations. Since 2008, there has been a growing body of journal articles that investigate the politics of major bilateral trade and investment issues of great political significance to both countries.

Yu Changsen and Jory Xiong examine the current features of the Sino-Australian relations from the perspective of asymmetrical interdependence. Having analysed the patterns of relative sensitivity and vulnerability, Yu and Xiong argue that both countries are sensitive to policy shifts made by the other given the structure of the trade relationship, and that Australia is vulnerable in that she is not able to choose her major trading partner (Yu & Xiong, 2012).

Richard Leaver is one of the few Australian scholars who has paid close attention to the politics of Australia's iron ore war with China. Leaver offers an insightful review of the hurdles over the iron ore price issue since 2010. He criticises the Australian government's approach to the iron ore relationship and disputes with China, suggesting a long-term approach on the part of the Australian government to ensure the sustainability of the iron ore business with China is desirable (Leaver, 2010).

Bruno Mascitelli and Mona Chung discuss the significance of the arrest and trial of Stern Hu in the context of the struggle over iron ore pricing and Rio Tinto's difficult relationship with the Chinese authorities and businesses. Their works analyses the implications of the incident for Chinese-Australian relations and foreign businesses operating in China (Mascitelli & Chung ,2011; Mascitelli & Chung, 2012). The failed Chinalco-Rio deal is also the topic of discussion for Yao Shujie and Dylan Sutherland, whose study sought to explore the motivations for China's outbound foreign direct investment in Australia's resource sector, in relation to China's growing resource needs and attempts at nurturing Chinese national champions on the world stage via the 'going-out' strategy (Yao & Sutherland, 2009).

James Laurenceson's work compares the state of Chinese and other foreign investment in Australia and attempts to account for the causes for the 'immaturity' of the Chinese-Australian investment relations. Laurenceson is critical of Australia's restrictive and discriminatory approach towards Chinese investment and urges the Australian authorities to further improve the investment environment for Chinese businesses (Laurenceson, 2013).

Peter Drysdale and Christopher Findlay also share the view that Australia's foreign investment regulatory regime has become unnecessarily restrictive and discriminatory in response to the surge of Chinese state-owned investors in Australia's resource sector. Their study finds 'no persuasive case' for regulatory discrimination against government investment from China, and suggests that anxiety about the question is unfounded as it was in earlier times over the growth in foreign investment by Japan (Drysdale & Findlay, 2009). In a comprehensive overview of Australia's economic relations, Findlay also criticises Australia's approach to approval of Chinese investment projects for being 'unnecessarily discriminatory', and creating opportunities for Australia's competitors and risking trade relations with China (Findlay, 2011).

Jeffrey Wilson defends the Australian approach towards Chinese investment in the minerals sector, and discusses the shift in Australian government's foreign investment regime in relation to the characteristics of the Chinese mining FDI and the dilemmas it presents to the Australian authorities. Wilson suggests that Australia's regulatory response to Chinese investment is entirely legitimate, defensive and restrained; instead of being the result of resource nationalism, it is actually aimed at defending market liberalism (Wilson, 2011).

In their analysis of the resource politics between China and Australia, Mark Beeson and Li Fujian's article illustrates the impact of the resource ties with China on Australia's economy and domestic politics, and underscore the growing tension between Australia's geo-economic and geopolitics interests. Given the display of overt hostility in Australia's strategic posture, Beeson and Li suggest that the bilateral economic relations are rendered increasingly uncertain by Australia's strategic choice, together with the frictions caused by the incompatibility of the two countries' respective economic and political institutions (Beeson & Li, 2012)

Mark Beeson, Mills Soko and Wang Yong undertook a comparative analysis of China's resource partnerships with resource-rich middle powers. The study compared the resource politics between Australia and China with that between South Africa and China. The authors observed that Chinese investment in Australia is politically more controversial than in South Africa, and that the resource ties between Australia and China prove to be an uneasy partnership. This despite the fact that both sides have no choice but to make it work since material interests are likely to override ideological preferences in this new resource politics. They assert that Australia must adjust to the political and economic impact of closer ties with China, and eventually come to terms with China by dealing carefully with the misalignment between its economic and strategic interests (Beeson, Soko & Wang, 2011).

There are also some studies on the ongoing Free Trade Agreement negotiations between China and Australia (Cheng, 2008; Tran, 2008; Leahy et al*.,* 2008; Yang, 2008). Yang Jiang's work seeks to explain the slow progress of the FTA negotiation, as well as China's negotiation approach, by looking into domestic political resistance in China and China's policymaking institutions (Yang, 2008).

Dynamics of Sino-Australian relations can also be found in the trilateral relationships between China, Australia and a third party. This trilateral approach was applied in the early 1990s to study the relationships between China, Australia and Southeast Asia (Wang, 1992). In the literature on Chinese-Australian relations, the United States has been given the most attention amongst all other third parties. Australia's China policy is constrained by American attitudes towards China. This fact is widely acknowledged amongst students of Chinese-Australian relations. Scholars have increasingly registered the risk that the bilateral relations could easily fall victim to the volatile U.S.-China strategic relationship in the face of China's rising power (Malik, 2001; Wesley, 2007a).

This trilateral interplay also frequently occurs in the literature on the U.S.-Australian alliance in recent years. Some Americans advocate strengthening the Australia, New Zealand, United States Security Treaty (ANZUS) alliance to contain China (Baker & Paal, 2000). The Australians, however, are much less antagonistic towards China; they call for greater policy independence and are not afraid of upsetting the Americans by acknowledging their tension over attitudes towards China within the alliance. Amongst those who continue to see the merits of the alliance, some tend to take a sanguine view of the tensions and even see a mediating role for Australia in moderating U.S. strategic perceptions of China so as to facilitate more stable Sino-American relations (Rudd, 2001). For the more nationalistic Australians who oppose Australia's subservience to the United States, the discord is simply another instance of American contempt for the national interest of its junior ally: U.S. pressure over Australia's China policy regarding Taiwan would inevitably put Australia at risk of being dragged unnecessarily into a great power conflict (Fraser, 2001).

The China-U.S.-Australia interplay became an important topic of research in Australia during the 2000s, and there are works devoted specifically to this set of trilateral relations. The first detailed study of the triangle appeared as a monograph in the late 1990s (Harris, 1998b). Thereafter, at least eight academic journal articles on the subject were produced up until 2007.

Some of these are geared towards the discussion of the impact of China's rise on the U.S.-Australia alliance.(Harris, 1998b; Malik, 2005, 2006). Others approach the question from the perspective of Australia's strategic posture by highlighting the foreign policy dilemma faced by Australia in balancing its relations with the two great powers (Tow & Hay, 2001; Tow, 2005; White, 2005; Pan, 2006; Tow & Yen, 2007).

As China's power grows, realists are doubtful about the prospect of an easy strategic accommodation between China and the United States (Tow, 2005; White, 2005, 2007). If their strategic competition intensifies, both great powers are likely to try to pull Australia into their orbits of influence by imposing excessive and countervailing expectations and make Australia's efforts at neutrality difficult (Harris, 1998b; Tow, 2005; Wesley, 2007a).

The United States is worried about the strategic consequences of Australia's growing dependence on China for economic growth. It demands that Australia follow the U.S. lead on a range of China-related issues where vital U.S. interests are at stake, such as the defence of Taiwan and how to respond to China's rising power (Harris, 1998b; Tow & Hay, 2001; Tow, 2005; Malik, 2005, 2006). China on the other hand, is deeply unsettled about the prospect of Australia joining America in containing China and depriving China of its right to reclaim Taiwan (Tow & Hay, 2001; Tow, 2005).

Australian responses to the predicament are varied. Some call for a decoupling strategy to preserve Australian neutrality (Wesley, 2007a). Others propose dialogues and consultations as confidence building measures to avoid miscalculation, misperception of intentions and inflated expectations on Australia (Tow & Hay, 2001; Tow, 2005; Pan, 2006). Some entertain hopes of encouraging the United States to maintain its engagement strategy and curb the influence of the neoconservatives in America and at home (Tow & Hay, 2001; Pan, 2006). U.S. hardliners assert that the different perspectives on China between the United States and Australia, are due to Australia’s fallacious assumptions and misperceptions of China rather than their diverging interests; sitting on the fence is never an option for Australia, which will ultimately side with the United States in the most difficult situations (Malik, 2006).

There are also competing views on China’s intentions towards ANZUS. According to the more relaxed interpretation, China recognises and accepts its long history and, subject to its character not changing, its contribution to regional stability; the Australia-U.S. alliance in itself is not problematic for Australia’s relationship with China (Harris, 1998b). The more cynical voices, however, point to Chinese concern about Australian susceptibility to U.S. influence, and Chinese efforts to use her economic clout to convert Canberra into a more independent security actor (Tow, 2005). The most alarmist interpretations highlight China’s desire to eventually neutralise the San Francisco alliances system by economic and security diplomacy that undercuts alliance politics (Tow & Hay, 2001); some alarmists believe that Beijing still harbours ambitions of driving a wedge between Australia and the United States (Malik, 2005).

Nevertheless, there is a consensus amongst all analysts that the alliance remains robust. Many indeed believe that discord over China has not endangered Australia’s alliance with America; China will not succeed in dividing the alliance, because it is based on shared values and common regional and global strategic interests; and Australia has a considerable interest in a strong Australia-U.S. relationship (Harris, 1998b; Malik, 2005, 2006). From the Australian perspective, Australian discontent with the alliance is unlikely to hinge centrally on the relationship with China (Harris, 1998b). A careful survey of the vast literature on ANZUS confirms this as a common opinion.

Since 2008, there has also been a revived research interest in the China-Australia-U.S. strategic triangle and the U.S. factor in Australia-China Relations. This more recent literature focuses not so much about the bilateral relationship between Australia and China *per se* as Australia's foreign policy. More specifically, this group of writings discuss Australia's relationships with China and the United States in the context of the strategic triangle. The main concern that runs through this body of literature revolves around the question of whether Australia is able to reconcile its most important trading partnership with China with her indispensible traditional alliance ties with America.

Shannon Tow surveys Australian efforts to reconcile Chinese-Australian relations with the ANZUS alliance during the period between 1971 and 2007, and elaborates on how Australia's leaders have managed to expand the country's relations with China under the Whitlam, Hawke and Howard administrations without jeopardising alliance relations with America (Tow, 2012).

Hugh White's works offer an extensive treatment of the strategic dilemma facing Australia in the current era of shifting global power dynamics (White, 2010, 2011). Having assessed the changing power dynamics between China and the United States, White sets out his policy recommendations for rethinking Australia's strategic orientation in the Asian century. White's proposal of an Asian 'Concert of Powers' arrangement is centred on the idea of the United States conceding American strategic primacy and sharing power with China in Asia, if China manages to surpass the United States in national power in the future. White's thesis has provoked widespread and sharp criticism in Australia, and initiated a heated national debate around Australia's strategic choice vis-à-vis China and America, as well as the regional security order in the age of power transition. Carlyle Thayer's account of Australian responses to White's thesis offers an interesting insight into Australia's mainstream attitude towards White's advocacy of accommodating Chinese power on the part of the United States and regional countries including Australia (Thayer, 2011).

In response to White's thesis, many Australian scholars have come up with alternative visions of regional security architecture and policy prescriptions for Australia. For instance, He Baogang criticises White's proposal of a 'Concert of Powers' for overlooking the role of the Association of Southeast Asian Nations (ASEAN) and suggests that Australia should embrace a regional security order that is centred on both

ASEAN-led regionalism and the ‘Concert of Powers’ mechanism to constrain the domineering influence of great powers, the United States and China alike (He, 2012b).

Derek McDougall’s work also discusses Australia’s strategies in the face of China’s rise in power in relation to the United States. In response to White’s thesis, McDougall suggests that the best option for Australia to constrain Chinese influence is a hedging strategy that combines soft balancing and accommodation, since ‘in the normal flux of international politics’ Australia does not have to choose between the United States and China (McDougall, 2011).

Lowell Dittmer also advocates a triangular perspective on Sino-Australian relations with reference to the United States. Dittmer concurs with the view that the incompatibility between Australia’s relationships with China and America is not yet significant, and criticises White’s ‘Concert of Powers’ idea for being unsustainable on the grounds that Beijing may not agree with the arrangement. He continues that Australia may eventually be forced to choose if China gets powerful enough and coexistence with continuing U.S. strategic presence in the region becomes intolerable for the Chinese (Dittmer, 2012).

You Ji’s work analyses the U.S. factor in the strategic dimension of Chinese-Australian relations, suggesting that as the Chinese military capabilities continue to grow and challenge U.S. strategic primacy, Australia faces the risk of being drawn into an unwanted major power confrontation between China and America (Ji, 2013).

Scott Dewar also presents an analysis of the trilateral great power politics between Australia, China and the United States. Dewar warns that for Australia, the U.S. alliance and the economic partnership with China will become irreconcilable in the foreseeable future. In response to White’s idea of Washington ceding strategic primacy to Beijing, Dewar asserts that the power reality ‘is nowhere near that point yet and it may never come’. Nevertheless, Dewar holds the view that China would not expect Australia to end alliance relations with America and there is scope for Australia to develop a closer political relationship with China (Dewar, 2011).

He Baogang provides a critical overview of Australian, Chinese and American perceptions of the triangular politics. Having reviewed the three national perspectives, He stresses the need for more trilateral dialogue on the subject if the Australian debate initiated by White is to have any real and wider policy impact in Asia for the management of the strategic triangular politics between China, America and any regional U.S. ally/security partner, such as Australia (He, 2012a).

### 1.4.3 The Broader Literature

There is a broader body of literature relevant to this study, particular on Chinese outbound foreign investment and the role of state-owned enterprises (SOEs). The works of Rosen and Hanemann examine the drivers and implications of Chinese outbound foreign direct investment mainly in the European context (2009, 2012). In the African context, Bräutigam and Tang closely follow the development of Chinese investment in the special economic zones (2011, 2012), while the issue of 'China Inc.' is examined by Taylor and Xiao (2009). Liou's studies the role of Chinese SOEs, focuses on the overseas expansion of central SOEs (2010), as well as the bureaucratic politics in the overseas expansion of Chinese oil companies (2009). Downs' works examines the role of China's oil companies as business interest groups (2008, 2010). Breslin's study of government-industry relations in China is a good starting point for understanding the role of Chinese SOEs in overseas investment (2012b); while his analysis of Chinese resource foreign policy is also a relevant work as far as China's resource diplomacy is concerned (2012a). Linda Jakobson's research on new foreign policy actors in China also offers insights into this issue (Linda & Knox, 2010). Her analysis of the role of economic actors such as the big, powerful SOEs and industry associations in Chinese foreign policy making is revealing and suggestive of the difficulties in terms of access to data. This broader literature provides valuable insights into the role of Chinese SOEs in China's outbound foreign direct investment and foreign economic policymaking.

### 1.4.4 Critique of the Existing Literature and Contribution of the Thesis to the Studies of China-Australia Relations

The existing literature on China-Australia relations has four areas of inadequacies. The first issue is the lack of treatment of the Chinese policy perspective. The second problem concerns the lack of discussion of the interaction between the resource ties and the strategic dimension of the bilateral relations. The third problem relates to the relatively narrow focus on the realist perspective in the analysis. Finally, the domestic dimension deserves greater research attention insofar as the Chinese side of the story is concerned. These four areas of weaknesses apply to both the earlier works on the bilateral ties well as the more recent writings on the subject. The aim of this general critique of the existing literature on the bilateral relations is to briefly explain where this study sits and what it adds to the existing research.

By and large, the lack of treatment of the Chinese policy perspective is a common problem. As mentioned in the previous review, it is fairly obvious that a more substantial analysis of China's policy approach and concerns is lacking in the works by Chinese scholars as well as the English language sources. More often than not, the existing literature only contains passing reference to China's policy. Instead, the discussions tend to be heavily influenced by Australia's policy concerns and dilemmas. Efforts have been made to address this inadequacy in the recent studies of the bilateral resource politics from 2008 onwards; but overall the existing scholarship does not offer a balanced account despite a few notable exceptions.[13] The discussion remains skewed towards the Australian side of the story and fails to thoroughly cover the Chinese policy perspectives and agendas. Most of the recent literature continues to shed light mainly on Australia's policy concerns, such as the country's alignment vis-à-vis China and America in the strategic triangle, the question of how to accommodate China without having to lose her autonomy, and the growing tensions between geopolitical imperative and geo-economic interest in Australia's China ties. What has been insufficiently addressed in this intellectual discourse is the Chinese side of the story.

This study offers a thorough analysis of the Chinese policy thinking and is more reflective of China's policy concerns and priorities, especially with respect to the resource issues. The roles of the various transnational Chinese actors involved in the bilateral undertakings, so as the important domestic sources inside China, are so important for understanding the evolving power dynamics between the two countries

[13] A notable example of such exception is the joint research report on the bilateral relations produced by the Australian Centre on China in the World (CIW) and China Institutes of Contemporary International Relations (CICIR) (CIW & CICIR February 2012). This high-profile joint report offers a distinct overview of all the major aspects of the bilateral relationship and incorporates insights and perspectives from the officials and policymakers of both countries. The report stresses the importance of social and cultural links and the need to diversify the bilateral ties beyond economic interdependence, as well as the urgent need to adapt the bilateral strategic relationship to the rapidly changing geopolitical environment in the Asia-Pacific.

towards the end of the 2000s. The extensive analysis of the iron ore pricing issue in this thesis is a major contribution to the discussion of the Chinese side of the story. It is worth emphasising here that this particular policy issue has so far received very limited research attention from the students of the bilateral relations despite its huge policy significance to the Chinese. This thesis has explained in detail why and how this issue has caused a huge political controversy in China and become a major policy agenda. The thesis also covers extensively the analysis of the Chinese policy motivations and perceptions of the Australian discrimination against Chinese government investment in Australia. Most importantly, this study has helped illustrate the paradox of China's rise by examining both her rising power and entrenched vulnerability in the resource power politics versus Australia. Since the existing academic discourse on the bilateral relations is very much overwhelmed by the perception of China's rise, the vulnerability aspect has been largely neglected in the discussions. By focusing on Chinese vulnerability, this study hopes to offer a more accurate depiction of China's rise in the context of China-Australia relations.

Secondly, the existing literature on the bilateral relations tends to isolate the discussion of economic issues from the strategic analysis of the geopolitical dimension. As pointed out in the previous review, many studies tend to divide the bilateral relations into the political, security/strategic, and the economic domains without addressing the links between them. This is especially common in book-length studies. Another common tendency is to focus exclusively on the analysis of either economic or strategic issues in a research articles without considering the interplay between the two dimensions. Such a 'compartmentalised' approach does not fully reflect the reality of the bilateral relations given the close interactions of geopolitical dynamics and economic issues. As this thesis argues, the progress in China's political relationship with Australia is largely underpinned by the economic ties centred on resource coopeartion. Again, even the more recent literature has showed little improvement in this regard; despite one or two exceptions, the majority of the recent studies on the resource relationship and the academic discourse on geopolitical issues fail to make any major breakthrough in this regard.

This study has attempted to make an explicit link between geopolitics and the vital resource ties. It analyses the geo-strategic context for the bilateral resource politics and investigates how the changing patterns of the geopolitical/security relationship has shaped the scope and nature of the resource partnership. In particular, arguments have been made from the Chinese perspective about the policy dilemma faced by China in relation to the growing tensions between her vital resource interests that are at stake in the resource ties with Australia and the deteriorating security relationship that is set to constrain and pose strategic risks for the development of the resource partnership.

The third problem of the existing scholarship of China-Australia relations relates to the relatively narrow focus on the realist perspective in the analysis of the bilateral ties. To a large extent, the existing literature tends to discuss the bilateral relations under a realist framework. Much of what has been said about the bilateral relations reflects realist concerns for the traditional security agendas pertaining to alliance and strategic alignment behaviour. For instance, the intense debates about Australia's strategic response to China and the continued research interest in the Australia-China-U.S. strategic triangle have constituted a significant proportion, if not the majority of the academic writings on Chinese-Australian relations. On the one hand, this is understandable because the rise of China has posed an unprecedented strategic dilemma for Australia; from the Australian perspective, it is entirely fair to devote the academic discussion to the country's biggest foreign policy challenge, at least from a realist perspective. On the other hand, such a realist-oriented academic discourse fails to depict the full complexity of the bilateral relations and fully reflect the Chinese perspective. For instance, such a realist approach largely fails to capture the vital transnational dimension of the bilateral relations. Given its focus on the inter-state (or to be more specific the inter-governmental) level, it tends to neglect the transnational political and economic processes that have in fact played a critical role in shaping the bilateral relations. A lot of political tensions and policy conflicts have emerged from the transnational level pertaining to resource and other economic policy agendas. Moreover, the realist concern for the security agenda and geopolitics does not accurately reflect the Chinese policy concerns and the Chinese resource interests that are at stake. This is because China's Australia policy is very much dominated by the resource security agenda, even though Canberra's strategic behaviour vis-à-vis China remains a relevant foreign policy concern for Beijing. Yet, despite the heavy reliance on realist insights, many existing works often fail to acknowledge and declare the theoretical assumptions behind their empirical analysis.

This study has not only explicitly clarified its theoretical assumptions but also adopted a more neoliberal analytical approach that emphasises the economic agendas and the idea of interdependence. Instead of relying on the more conventional realist perspective, the study has mainly drawn on the theoretical insights of complex interdependence theory for the analysis of resource-related policy issues. This neoliberal perspective on the bilateral relations has allowed the research to focus on the important economic issues that are actually high up on China's policy agenda and helped capture some of the most important political and economic dynamics at the transnational dimension. Moreover, the neoliberal theory of asymmetrical interdependence has enabled this study to combine the realist focus on power with the liberal focus on (economic) interdependence in the analysis of the bilateral resource power politics under extensive economic interdependence, where the traditional realist conceptions of power politics do not appear to be readily applicable. Furthermore, as will be explained in the subsequent section on theory, the 'spectrum' perspective of complex interdependence theory has also given enough scope for the analysis of the realist-oriented security dimension and its relationship with the resource issues.

Last but not least, the thesis hopes to make a modest contribution to the literature on China-Australia relations by giving a more in-depth analysis of China's domestic economic and political factors and how they may affect China's policy and power position vis-à-vis Australia especially in the resource power politics. To some extent, the full implications of China's domestic economic processes on the bilateral relations have not been fully appreciated by the existing scholarship. It is often acknowledged by the academic discourse that China's economic growth and domestic economic transformations have been instrumental in the development of the bilateral economic partnership. However, there is still a lack of in-depth analysis of how some of the domestic factors have shaped China's dealings with Australia, not least with respect to the bilateral resource politics. In fact, even those works on resource politics fail to give an in-depth account of the relevant Chinese domestic factors and their implications for the resource ties. Arguably, this inadequacy is partly attributable to the above-mentioned relative neglect of the transnational dealings in the existing scholarship. As this study shows, much of the analysis of the politics of inter-state and transnational economic relations would indeed require a thorough examination of the domestic sources. Insofar as this research is concerned, the thesis has looked into the various relevant domestic and industry-level factors, such as the roles and interests of the various Chinese market actors and the structural economic problems faced by the resource-dependent industries. Arguments have also been made in relation to the explanation of the political process of agenda formation (the rise of resource security agenda in China) and the domestic sources of Chinese vulnerability in the transnational struggle for iron ore pricing power. The empirical findings of these analyses could enrich the academic understanding of some of the major domestic constraints on China in the resource power politics versus the Australian mining companies.

## 1.5 Research Methods

This study relies mainly on qualitative data. As this research is concerned with recent events and policies, it does not use any archival materials. For this study, I have consulted both Chinese and English literature as secondary sources. Some of the secondary sources, especially the English-language academic works written by Australian scholars, are accessible at the London School of Economics and Political Sciences and in the U.K.; but they are of limited use in terms of providing the most relevant empirical materials for the purpose of this thesis. More fruitful secondary sources in the Chinese language are available in China, where appropriate books authored by Chinese writers tend to show greater relevance to the study in one way or another. Media coverage has been an important secondary source of data. Online information such as news reports and special coverage of relevant issues is abundant and has been extremely useful for the iron ore and investment chapters.

Fieldwork is indispensable for obtaining primary data. Three rounds of semi-structured key informant interviews were undertaken for this research. The Appendix provides more detailed information on these research trips. The first two rounds of fieldwork were carried out in Beijing and Shanghai (trip 2 and trip 3 in the Appendix), and the final round was conducted in Canberra and Sydney (trip 4 in the Appendix). In addition to the three major research trips, some interviews were undertaken in Shanghai during my internship at Shanghai Institutes for International Studies (SIIS) in the summer of 2009 and on the sidelines of the '12th International Conference of Australian Studies in China' in October 2010. The fieldwork was conducted mainly through research interviews with selected interlocutors. Efforts were made to broaden the scope of fieldwork by reaching out to as many interlocutors as possible, from both the foreign policy establishment and the industry.

It was difficult to gain access to policymakers, government officials, business practitioners and representatives of the mining and metallurgical industries. Practitioners in the diplomatic and business circles were much less approachable in my current capacity as a research student. Problems of accessibility and accountability however do not present an overwhelming barrier to the researcher's ability to examine the bigger picture.[14] Analysts based at independent think tanks in Australia and

[14] Again, this is compensated for by extensive media reports on the economic issues by Chinese journalists.

government-affiliated research institutions in China and university scholars were relatively more accessible. More viable alternative sources, such as academics at leading Chinese universities, were also available, while informed journalists, market observers and business analysts were also useful primary sources. Whilst the focus is on Chinese sources, the insights of Australian analysts were also proactively pursued in order to obtain a more balanced overall perspective.

Quantitative data is obtainable from open sources, and some qualitative data was available in the relevant academic literature on Chinese-Australian relations. However, many of the economic and industry figures used in this study are taken from news reports. Industry data contained in annual yearbooks prepared and written by relevant business associations, industry confederations and government agencies can be useful; but they were not available in the U.K. Published market research reports, industry reports and business analyses produced by investment lawyers, think tanks and universities also proved to be invaluable sources of relevant quantitative data.

# Chapter 2 From Post-9/11 to Post-2008: China's Rise and the Evolving Strategic Context

## 2.1 Introduction

This study's core research question is concerned with analysing the Chinese response to the evolving power dynamics which underpin bilateral resource politics with Australia. In order to address this topic, it is important to first examine the broader geopolitical context of the resource ties between these two countries, before examining the specific aspects of the bilateral resource politics. The first major research objective as set out in the introduction chapter is therefore to investigate the geopolitical background of the bilateral resource politics. Indeed, all economic ties between states emerge out of a specific political framework, and China's vitally important resource ties with Australia have developed out of the specific political context of Chinese-Australian bilateral relations. Although Chinese-Australian relations have first and foremost been driven by the development of resource ties, the bilateral economic relationship has very much been shaped by evolving geopolitical realities. The rapid development of these resource ties by and large began in the first decade of the new century. During the same period, the rise of China has transformed Australia's strategic environment, and Australia's reaction to China's rise has also shifted significantly over the short span of the 2000s. Thus, China's increasingly vital resource partnership with Australia has grown out of a highly dynamic political framework.

The purpose of this chapter is to provide the geopolitical context in which the bilateral resource politics between China and Australia has played out. It discusses the strategic dimension of the bilateral relations by investigating the evolving trajectory of the changing strategic dynamics between the two countries in the post-9/11 and post-2008 eras, respectively. The chapter begins with a survey of the post-9/11 geopolitical setting, which, together with China's economic rise, accounts for the Sino-Australian entente which emerged during the Howard years in the post-9/11 era. The second half of the chapter examines how and why the strategic dynamics of the bilateral relationship has deteriorated since 2008 in relation to some systemic changes in the wider regional geopolitical setting such as: China's increasingly expansionist foreign policy posture; Australia's changing strategic attitude towards China's rise; and the new Australia-U.S. alliance dynamics targeted against China.

This background analysis of the geopolitical context is highly relevant for understanding China's relative power position vis-à-vis Australia, and her policy response in the bilateral power struggles over Chinese investment in Australia's resources sector and iron ore pricing, which are the focus of the ensuing chapters. By illustrating the ups and downs of the bilateral relations during the post-9/11 and post-2008 eras, the strategic analysis provided in this chapter will help readers to better appreciate the delicate geopolitical context of the bilateral resource ties and its implications for the development of this resource partnership. As the subsequent chapters will illustrate, the precarious nature of this bilateral political relationship has seriously limited the potential for economic cooperation and prevented China and Australia from establishing a reliable and intimate resource partnership.

In this chapter I argue that China's delicate strategic relations with Australia underwent major changes in the first decade of the new century. Bilateral relations improved significantly during the post-9/11 era, but there has been a serious deterioration in the strategic dimension of the bilateral relations since 2008. China's growing economic salience combined with her posture of strategic restraint in the post-9/11 era significantly improved the way in China's rise was viewed by the Howard government. Her strategic restraint, together with the Bush administration's preoccupation with the War on Terror and the Middle East, led to a period of stability in China-U.S. relations; thereby providing a generally permissive strategic environment for a Sino-Australian entente to occur in the post-9/11 era. However, China's growing power and her assertive and expansionist behaviour since 2008 has resulted in the deterioration of the regional strategic environment, with growing tensions between China and the United States and intensified security competition and strategic rivalry between China and her neighbouring states. In response to the new strategic uncertainty amidst power shifts in the post-2008 era, Australia's strategic stance towards China has hardened. As the Labour government reassessed the strategic implications of China's rise, Australia endeavoured to reorient her foreign policy away from China, build up her defence capabilities and adapt her alliance with the United States to challenge China's rise. Hence, the strategic dimension of post-2008 Chinese-Australian relations has been marked by revived strategic tensions and competitive realist dynamics.

The geo-strategic context set out in this chapter underlines the geopolitical constraints faced by China in conducting bilateral resource power politics vis-à-vis Australia. Although this chapter itself only seeks to analyse the strategic dimension of the bilateral relations, its findings nonetheless provide important insights into the political context of the resource politics, which in turn reinforces the central argument of this thesis. As the ensuing chapters on the specific issues of resource politics will show, the nature and scope of the bilateral resource ties were in no small measure affected by the geopolitical realities emerging from the broader relationship. Indeed, one major argument of this thesis is that geopolitical constraints set the limit on bilateral resource cooperation. The geopolitical realities of Chinese-Australian relations entail considerable strategic uncertainty and political constraints on the development of a genuine, deep and reliable resource partnership between the two countries. Chinese efforts to maximise resource interest therefore continually come up against inherent political risks in the bilateral relations. Despite Australia's important role in ensuring Chinese resource supply, the revived strategic tensions in Chinese-Australian bilateral relations during the post-2008 era have begun to undermine China's resource security interests. Unfortunately, China is hard pressed to find a way of circumventing this geo-economic dilemma in her resource relations with Australia.

Against this context, I have chosen to use complex interdependence theory to help make sense of this strategic aspect of China-Australia relations. This theory presents a spectrum of world politics whereby the typical situations of complex interdependence and realism are ideal types whilst most situations of world politics will fall somewhere between the two extremes. Accordingly, one needs to understand the degree to which realist or complex interdependence assumptions correspond to the actual situation under analysis, or where that particular situation of world politics sits on the spectrum, before deciding which explanatory model to apply to a situation or problem (Keohane & Nye, 2011: 20). This means that the position of a given situation along this complex interdependence-realism continuum has real world implications, and constitutes an important independent variable for analysis. In other words, the analysis of the resource politics between China and Australia depend on its specific position on the spectrum.

In this regard, it can be said that the condition of Chinese-Australian relations does not strictly reflect the ideal-type of complex interdependence. This is because realist dynamics are ever-present in the bilateral relations, due to inherent strategic tensions between China and Australia. Their divergent strategic preferences, geopolitical interests and political outlooks, together with East Asia's precarious regional security environment and rapidly changing power structure, mean that China's relations with Australia always contain a significant geo-strategic dimension under the sway of realist logic. In this regard, the revived strategic tensions in the bilateral relations, which flared towards the end of the 2000s, mark a further shift towards the realist end of the continuum. The realist dimension and the apparent recent shift towards realism on the spectrum, have to be taken into consideration in any analysis of the bilateral resource power politics. As the subsequent chapters will demonstrate, the inherent strategic uncertainty and revived tensions between China and Australia have imposed considerable constraints on the development of the resource partnership. The very existence of these realist dynamics, means that China's resource ties with Australia are developing within a constrained and precarious political framework.

Despite this chapter's emphasis on the realist dynamics of the strategic dimension, the forces of economic globalisation have arguably still prevailed in the context of Chinese-Australian bilateral relations. After all, there have been no major strategic conflicts or direct confrontations between China and Australia. Both Beijing and Canberra have been careful not to let the worsening security dynamics jeopardise their vital economic ties and interests. To some extent, deepening economic interdependence and continued growth of the resource partnership are indicative of the strength of the bilateral economic ties. What this means in theoretical terms is that Chinese-Australian relations are nonetheless still situated closer to the complex interdependence end, rather than the realist end, along the continuum. In other words, insights from the complex interdependence theory remain valid as providing a more relevant and appropriate explanatory model than a realism-focused theoretical framework for analysis of China's resource politics with Australia, as will be shown in subsequent chapters. Indeed, the predominance of complex interdependence is also the logic that underpins the background analysis provided in Chapter 1, which sets out the overall characteristics of China-Australia relations in terms of complex interdependence.

## 2.2 Post-9/11 Global and Regional Geopolitical Setting: 2001-2007

China's strategic relations with Australia have been shaped by global and regional geopolitical dynamics. The security stance taken by the United States has been the most decisive factor in this regard. George W. Bush came to power in 2001 with a weak electoral mandate and a hawkish eye on relations with China. However, the terrorist attacks on 11th September completely transformed U.S. foreign policy and Bush's presidency, triggering a series of systemic effects on international politics. The War on Terror, the Middle East and the non-proliferation of weapons of mass destruction became the three prongs of U.S. global security strategy. The United States waged its global War on Terror, toppled the Taliban regime in Afghanistan that harboured Al-Qaeda, singled out Iran, Iraq and North Korea as the 'axis of evil' amongst rogue states, invaded Iraq without U.N. sanctions and brought down the Saddam regime. The terrorist attacks and America's quick military victories in Afghanistan and Iraq boosted domestic support for Bush's presidency, making him a 'War President' and counterterrorism the centrepiece of American politics.

The two wars once again demonstrated the supremacy of America's unrivalled military might. U.S. strategic penetration of Central Asia and its increased involvement in the Middle East were some of the immediate strategic gains. However, both the Iraq and Afghanistan wars cost America money and lives, preoccupied America's strategic planning, and consumed its diplomatic and military resources. America's image as a 'world leader' was also tarnished by its *de facto* war against the Muslim world in the anti-terrorist campaign, its diplomatically unpopular and illegal invasion of Iraq, and the subsequent failure to find weapons of mass destruction (WMDs) in that country as well as the torture and ill-treatment of terrorist suspects. These actions weakened the transatlantic alliance, and undermined U.S. soft power and the legitimacy of American hegemony and leadership. Anti-U.S. sentiments became pervasive across Europe and the Muslim world when the Bush doctrine and neo-conservatism came to be regarded as destabilising and imperialist. East Asia (especially Southeast Asia), where Chinese influence continued to expand and U.S. hegemonic power was still admired and relied upon by most of the countries in the region, was very much neglected by the Bush administration, which became bogged down in the quagmires of Middle Eastern geopolitics.

The post-9/11 transformation of U.S. foreign policy gave fresh impetus to the Australia-U.S. alliance. Howard was in Washington on the day of the terrorist attacks witnessing the tragedy unfold, and he immediately seized an historic opportunity to further strengthen the alliance. Australia proved its value and loyalty as a junior ally by fully committing itself to U.S. security needs in the post-9/11 era. It invoked the ANZUS treaty immediately after the terrorist attacks, contributed troops to the war efforts in Iraq and Afghanistan and joined the Proliferation Security Initiative. The Bali bombings in 2002, which killed 88 Australians, further strengthened the case made by the Howard Administration for Australian engagement in the U.S.-led global War on Terror. Howard managed to convince the Americans that Australians shared Americans' sorrow and security concerns, and a close bond was thus forged between him and Bush (Sheridan, 2006; Garran, 2004).

Not least for alliance considerations, Howard sought to bring Australia in line with the United States on strategic assessment and revolutionised the way in which Australia perceived and responded to its security challenges. Howard spearheaded the transformation of Australian defence strategy from the 'continental defence' approach ('Defence of Australia' doctrine) to a 'forward defence' posture with the aim to build up the expeditionary capabilities to deal with low-intensity contingency operations against non-state security challenges globally (Dibb, 2006; Dupont, 2003; White, 2002). This changing defence posture was also designed to make Australia more useful to the United States by raising its military capability to help fight America's war (Kelly, 2006). Indeed, support for American war efforts had always been enthusiastically embraced by Britain and Australia, so much so that the Anglo-sphere has come to be seen as the main countries that wage war. Having kept Australian causalities on the battlefields to a minimum, Howard managed to sustain domestic support for Australia's participation in the military campaigns (Kelly, 2006).

Even when the United States later became more isolated internationally, Australia showed its affinity with America and offered its wholehearted support entirely on its own initiative. The strategic dividend of this alliance policy was tremendous for Australia. Allied intelligence cooperation deepened as Bush granted Australia unprecedented access to U.S. intelligence resources, bringing Australia to the most exclusive inner circle of intelligence collaboration - the '3 ears only' countries along with Britain (Sheridan, 2006). Australian dependence on alliance with America was further entrenched as Australian armed forces were given more access to America's most advanced military technology and resulted in a revolution in Military Affairs. Howard was proud of Australia's unprecedentedly close relationship with America, as the junior ally was increasingly regarded as the 'Britain of the Asia-Pacific'. For a middling power like Australia, this constituted a remarkable foreign policy achievement. The level of trust between Australian and American leaders was at a historic high. Insofar as Chinese-Australian relations were concerned, this intimacy and mutual trust gave Australia considerable room for manoeuvre in dealing with a rising China without damaging its alliance with the United States.

By the time Bush came to power, the United States had already begun to experience the strategic challenge emerging from China's rise. An acknowledgement of the Chinese threat, however it was defined, had been growing in the United States since the beginning of the new century. China was anxious about the new Bush administration's China policy, when American power was at its height and the global power structure was heavily unbalanced in favour of the United States, particularly during the first years of Bush's presidency. The Chinese leaders were acutely aware of the fact that China was at the receiving end of U.S. hegemonic power in what was clearly a unipolar era. Whilst the search for strategic stability with the United States remained China's top foreign policy priority at the turn of the century (Wang, 2005), the events of 9/11 and its consequent impact on U.S. global strategy offered the Beijing leadership a golden opportunity to mend China's ties with the superpower and cultivate a sound working relationship with American leaders. Having seized this 'historic strategic opportunity', China pursued a successful foreign policy that enabled Beijing to build a positive and stable strategic relationship with Washington and to maintain a generally stable external strategic environment.

Beijing chose to align itself with Washington by cooperating with America on counterterrorism and a non-proliferation agenda, and avoided confronting the Bush administration on the U.S. decision to invade Iraq before and after supposed termination of the war. While the Bush administration focused on the chaos in the Middle East, China shouldered U.S. burden by playing a constructive and 'leading role', with U.S. encouragement, on the North Korean nuclear issue in the Six-Party diplomacy. As China's economic presence and interests expanded globally, the United States found China's cooperation increasingly important on a range of issues such as North Korea, Iran and Sudan, etc. When Chinese cooperation became indispensable on nuclear non-proliferation, U.S. debt financing and global economic governance, a stable, pragmatic and constructive working relationship with Beijing became invaluable to the Bush administration

As China's economic growth continued apace, China's trade, investment and financial links with America further developed, and mutual dependence between the two economies reached an unprecedented level. Despite the 'symbiotic' economic relationship, perception of the 'China threat' had never completely receded in U.S. strategic thinking. Hardliners in the U.S. defence and security establishment were becoming increasingly alarmed by China's growing regional influence and global profile, when the United States was concentrated on the Middle East and the global War on Terror. Yet, many American political and business leaders came to realise that the United States had a huge and growing stake in a stable and economically prosperous China. The U.S. government's official China policy was moderated by a more balanced view of China, and the Bush administration in effect ruled out the containment option (Wang, 2004). Engagement remained the cornerstone of Bush's China policy, where the guiding principle was to encourage China to become a 'responsible stakeholder'. Although China had already emerged as America's 'strategic competitor' in the Western Pacific geostrategic theatre, political necessity and strategic expediency forced the Bush administration to base its China policy on more balanced and pragmatic footing.

Beijing's foreign policy also remained cautious and prudent during this period. An important line of thinking underpinning Beijing's approach to international conflicts and frictions was that economic development was China's source of strength and the essential way leading to peaceful solutions to problems at home and abroad (Hou, 2008); it was thus deemed that difficult external foreign policy challenges should not be allowed to jeopardise economic development at home. The leadership succession between 2002 and 2004 brought no major changes to China's U.S. policy and bilateral relations. In part because of the revival of the notion of in 'China threat' in the region and in the United States, China lowered its previous anti-U.S. profile in the region and began to engage with a policy of reassurance by affirming its peaceful intentions and acknowledging the United States as a constructive player in regional security. When Sino-American relations improved after the September 11$^{th}$ incident, Chinese officials and analysts seemed more relaxed about their country co-existing with U.S. alliances in the Western Pacific. The development of Sino-American bilateral relations thus came to be regarded as having been in its ‘best shape in history’ by some U.S. leaders and Chinese strategists and officials during the period between 2003 and 2005.

Beijing’s approach towards the East Asian region was rather effective since the 1998 Asian financial crisis. China’s vision of ASEAN-centred ‘regional cooperation’ was based on proactive economic diplomacy, regional multilateralism and a reassurance strategy. Chinese economic concessions, efforts to promote economic integration with the regional countries, diplomatic engagement in multilateral regional forums, together with an accommodating posture of self-restraint on territorial and maritime disputes, largely dispelled regional fears of China’s rising threat and enhanced Beijing’s standing as a responsible regional power. Despite increasing tensions between Beijing and Taipei, the risk of military conflict and the independence movement on the island were contained by Beijing and Washington based on a *de facto* U.S.-China strategic coordination on the Taiwan issue. China’s cautious approach to maritime disputes in the South China Sea and East China Sea minimised the escalation of security tensions in Southeast Asia, as well as with Japan. China’s mediating efforts in the North Korea nuclear issue were appreciated in the region and the United States; Beijing’s diplomatic leadership was perceived as a critical contribution to non-proliferation efforts and regional stability. These developments were in stark contrast with the sense of insecurity (partly triggered off by the regional perception of Chinese bellicosity) experienced by the region in the early and mid-1990s, when China was widely considered to be a destabilising factor in regional security.

China was perceived by the Bush administration as a strategic 'peer competitor' to the United States. Although engagement remained the basic approach toward China during the post-9/11 era, the Bush administration also embarked on a hedging strategy to limit China’s hegemonic ambitions and strategic options by strengthening U.S. alliances. America spared no efforts to strengthen its existing major strategic alliances and security partnerships in the Western Pacific, and encouraged multilateral cooperation among its bilateral allies in the region[15] (Medeiros, 2005). It also reached out to countries

[15] A key function of this strategy was to encourage closer strategic coordination with and among its allies in their approaches to a rising China (Dibb & Blackwill, 2000). Policy coordination with respect to China was hard given differing perspectives held by America and its allies. As China’s power and influence continued to grow, American strategic policymakers were anxious about the widening gap between Washington’s views of how best to deal with Beijing and those of America’s Asian allies. The U.S. administration therefore worked hard to bring Asian allies into

such as Vietnam, Indonesia and India to seek new strategic partnerships. Among other security imperatives, the challenge of China's rise was a key factor driving these strategic moves. If the first Bush administration was mostly distracted by the chaos in the Middle East, East Asia was given relatively more strategic attention during President Bush's second term when conservative U.S. strategists grew more agitated about the implications of China's rise for American supremacy in the region.

Nevertheless, those developments need to be understood in the context of U.S. global priorities, whereby East Asia was not a major theatre. The Greater Middle East remained the focus of U.S. global strategy throughout the Bush presidency. The hedging strategy against the potential strategic risks brought by China's rising power did not amount to a containment strategy against China. President Bush himself was not interested in the containment of China; and his presidential preference was decisive in determining U.S. regional strategy towards East Asia.[16] U.S.-China strategic rivalry had yet to occur in the post-9/11 phase largely because of U.S. strategic neglect of the region (especially Southeast Asia) and Beijing's diplomatic prudence and strategic self-restraint in the region. Growing American anxiety over China's enhanced diplomatic status in East Asia had yet to be translated into any serious American efforts to contain or arrest China's diplomatic ascent in the region.

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line with American thinking by seeking to harmonise their opportunity and threat assessments concerning China's rising power, and to formulate a shared position on the Taiwan question among other issues of common concern. The United States was initially not fond of this idea, but had shown an increasing interest in this approach during the Bush administration under the influence of some American strategists who advocated creating an 'Asian NATO (North Atlantic Treaty Organisation)' to prepare for what they viewed as an upcoming Sino-American strategic competition (White, 2007). This U.S.-led multilateral security structure in Asia was designed to expand and draw in a wider group of hitherto non-aligned but pro-U.S. countries that shared America's concerns about the growing power of China.

[16] Source: Wang Jisi's public lecture on Chinese foreign policy in Nankai University, November, 2010, Tianjin.

## 2.3 Post-9/11 Sino-Australian Entente (Pre-2008)

Since the beginning of the new century, China's strong and sustained economic growth led to surging demand in China for overseas energy and mineral resources, propping up global commodity prices and intensifying global competition for energy and other raw materials. China began to take a more strategic approach to its increasing dependence on overseas resources. Resource-driven economic diplomacy became ever more important in China's relations with resource-rich countries. Insatiable Chinese demand for overseas natural resources fuelled a resource boom and propped up the economies in resource-producing countries. Economic ties based on cooperation in resources became the pillar of China's bilateral relations with those countries.

Sino-Australian relations had taken on a fundamentally new shape in this context. Indeed, resource-related economic diplomacy became the centrepiece of China's Australian policy since the 1990s. As Chinese demand for Australian resources rocketed, China's approach towards Australia was first and foremost shaped by Australia's relevance to China's economic objectives. During Chinese President Hu Jintao's visit to Canberra in 2003, the two governments singed the Trade and Economic Framework agreement. China also initiated its FTA negotiation with Australia in 2005, thus making Australia the second developed country that had begun FTA negotiations with China, after New Zealand.

China was careful not to let diplomatic troubles interfere with the burgeoning resource ties and trade relations with Australia. Bilateral political and security differences did not disappear; but their importance diminished as the resource agenda grew in salience. China began to place great stress on the economic complementarities between the two economies, and Australia came to be regarded as a critical and reliable resource supplier. Conscious of the strategic implications of the growing economic interdependence, Beijing also pursued economic diplomacy to advance its diplomatic agenda. However, Beijing did not have unrealistic expectations, and did not set out to divide the Australia-U.S. alliance (Harris, 1998b). Nevertheless, it was hoped that greater economic collaboration between the two countries could persuade Canberra to maintain a more balanced position between Washington and Beijing, especially on matters pertaining to Taiwan and other political and security issues in which important Chinese interests were at stake.

The exponential growth in bilateral trade and other forms of economic cooperation since the mid-1990s gradually became the cornerstone of Sino-Australian relations. Two-way trade in goods and services started to pick up speed towards the end of the 1990s, and underwent rocketing growth since the beginning of the new century. Over the last decade, the share of Australia's two-way trade in goods and services with China increased rapidly, from just 5.1 percent at the end of the 1990s to 17.6 percent at the end of the 2000s.[17] China had become Australia's largest merchandise trading partner in 2007, with two-way trade rising from AU$8 billion in the mid-1990s to AU$74 billion in 2008.[18] As dependence on Chinese demand for Australian minerals and energy resources continued apace, China's growing economic importance became apparent to the Australian leaders. The Australians increasingly came to regard China as an economic opportunity and even a critical determinant of Australia's Asia strategy. Consequently, the Howard government became eager to maintain a stable and cordial relationship with Beijing.

A subtle but significant policy shift was thus underway and remained steady as the Howard government began to adjust Australia's position on a number of issues concerning China. There was a growing perception of Australian acceptance of a Sino-centric view of Asia, as Australia had already begun to recognise that China should be accorded some kind of leadership role in Asia as its power grew. Australia appeared rather cautious about committing itself to any political and strategic initiatives sanctioned by America and its regional allies that might arouse Chinese suspicions of Australia's motives. A divergence of strategic outlook on China's rise began to emerge between Australia and the United States in this context.

The depiction of China in the declaratory policy of the Howard government became positive and remained so throughout the Howard years since 9/11 (McDowall, 2009). Canberra's strategic depiction of China contained three basic elements. The first was the recognition of China's vital economic importance

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[17] Source: 'China Tops Trade in Goods and Services' (December 22, 2010) http://www.dfat.gov.au/media/releases/department/2010/101222.html

[18] Source: 'Australia's Composition of Trade 2008' (June 17, 2008) http://www.dfat.gov.au/media/releases/department/090617_dmr_cot08.html

and its growing strategic weight as a significant regional and global power. The second was that the Australian government viewed the rise of China as an essentially positive process and the recognition that the behaviour of the rising China was generally responsible and benign. The third was that Australia's relationship with China was not confined to economic engagement but also encompassed a strategic dimension whereby China was deemed a valuable strategic interlocutor, albeit Australia's strategic relationship with China was not the same as its strategic partnerships with the United States and other American allies (such as Japan). The most formal policy enunciation in this regard was found in the 2003 foreign policy white paper, *Advancing the National Interest* (Department of Foreign Affairs and Trade, 2003). Accepting that 'China's growing economic, political and strategic weight is the single most important trend in the region',[19] the white paper chose to characterise Australia's relationship with China as a 'strategic economic partnership' (Department of Foreign Affairs and Trade, 2003). The same note was struck repeatedly in a number of significant foreign policy speeches made by Prime Minister John Howard, Foreign Minister Alexander Downer and senior Australian diplomats on various occasions. Howard saw a 'confident, peaceful and prosperous China, with an open market economy and constructively engaged in global and regional institutions, as an enormous asset for the Asia-Pacific region and the wider world' (McDowall, 2009).

Australia's strategic depiction of China began to diverge from that of the United States since the mid-2000s (McDowall, 2009). This divergence became rather apparent at the White House joint press conference between Howard and Bush in July 2005. While Bush's strategic depiction of China emphasised the sensitivities and complexity in the U.S.-China relationship, Howard's reflected a much friendlier tone. Prime Minister Howard conveyed a number of clear messages with regard to his understanding of Australia's role in the China-U.S.-Australia triangular relationship: first, the alliance relationship was rock-solid; second, Australia had good relations with both the United States and China; third, these relations were positive yet different at the same time; fourth, Australia had an optimistic view of the region's future; fifth, Australia was not an intermediary between the United States and China and

[19] China's rising power was already recognised by the Howard government as nothing short of 'the most important strategic development in the next fifteen years' in the 1997 foreign policy white paper (Department of Foreign Affairs and Trade, 1997). This official assessment represented a remarkable turnaround in the official strategic perceptions of China's rise and its significance to Australia since the normalisation of Sino-Australian relations (Tow, 2004).

did not wish to play the role of a mediator; and sixth, the alliance was not directed against China (McDowall, 2009).

In October 2003, Chinese President Hu Jintao was invited to address the Australian Parliament, an honour previously extended only to American presidents.[20] Washington was disconcerted by the display of symbolic parity in Australia's treatment of its relationships with America and China. Lest Beijing should feel as if it was being ‘ganged-up on’, Australia, to America’s disappointment, declined to participate in the so-called 'Halibut Group' in 2005, which was a series of private and secret multilateral meetings initiated by the United States on how to deal with the rise of China amongst selected U.S. allies and ‘like-minded’ countries. The United States also became increasingly concerned about the perceived Australian weakness in pressing China to improve its human rights practices, Australia’s clear inclination to separate economic issues from power considerations, its alleged vacillation in endorsing U.S. security treaty obligations in a regional context, and its refusal to join the United States and Japan in pressing the European Union (E.U.) not to lift its arms embargoes against China. Australia’s recognition of China’s market economy status in 2005 was one more gain for Beijing, especially when the United States, Japan and E.U. nations refused to grant such recognition to China.

During Foreign Minister Alexander Downer’s visit to Beijing in August 2004, he intimated that Australia would not automatically come to the assistance of the United States should it engage in a military conflict over the Taiwan Strait.[21] This might not have represented a change in Canberra’s official policy as Howard was quick to assure the United States of Australia’s awareness of its alliance obligations to the United States in the event of any conflict in the Asia Pacific shortly after Downer’s pronouncement.[22]

[20] U.S. President Bush also addressed the Australian Parliament, only one day before Hu’s address. This highly symbolic arrangement indicated Canberra’s intention to pursue both economic gains from China and security and strategic benefits from America, and not to choose sides between Beijing and Washington.

[21] In response to a carefully constructed question by the media regarding Taiwan, Downer said, ‘Well, the ANZUS Treaty is a treaty which of course is symbolic of the Australian alliance relationship with the United States, but the ANZUS Treaty is invoked in the event of one of our two countries, Australia or the United States, being attacked. So other military activity elsewhere in the world, be it in Iraq or anywhere else for that matter does not automatically invoke the ANZUS Treaty’ (Dobell, 2009).

[22] Downer’s remark immediately triggered off strong Australian and American responses. The U.S. State Department immediately corrected Downer, noting that if U.S. naval or air elements came under attack by China while they were defending Taiwan, Australia was obligated to come to their defence. Downer quickly retracted his original statement

Nonetheless the utterance of an alternative policy preference by the Australian Foreign Minister himself might have pleased Beijing;[23] and it gave a clear indication that the United States could not take Australia's assistance for granted over the Taiwan issue. After the passage of China's anti-secession law in March 2005, Downer was quoted as saying that the ANZUS Treaty could be invoked if war broke out across the Taiwan Strait, 'but that's a very different thing from saying we would make a decision to go to war' (AAP March 14, 2005). For many observers, Downer's contradictory and ambiguous remarks indicated a shift from the Howard government's previous clear-cut and tough stance on the issue.

While demonstrating mild defiance towards America's policy on China, Canberra did not forget to remind China that it did not want to make a choice between Beijing and Washington, and managed to do so without causing any fierce response from China. On many occasions, senior Chinese foreign ministry officials and diplomats explicitly or implicitly warned Australia not to invoke the ANZUS Treaty against China and even demanded a 'review' of the terms of the ANZUS Treaty to exclude a future Taiwan contingency (Tow, 2005). However, while publicly repeating its ambiguity over Taiwan, Canberra refused to give unequivocal assurance that it would satisfy the Chinese request for Australian neutrality in the event of a military conflict across the Taiwan Strait. Indeed, the Howard government was not prepared to go as far as some officials in Beijing would have expected.

Australia was earmarked by some American strategists as a potentially 'soft ally' with a weak military capability and 'limited geographic preoccupation' that, if left unattended, could lead to 'strategic myopia' (Baker & Paal, 2000, 87-110). The United States therefore sought to broaden Australia's perception of national interests and to encourage more active Australian involvement in Northeast and Southeast Asian security affairs. During President Bush's second term, a prominent objective of U.S. alliance policy towards Australia was to promote a common position vis-à-vis China. In this regard, America pushed for greater trilateral strategic coordination between the United States, Australia and Japan through the Trilateral Strategic/Security Dialogue (TSD). In the context of Australia's growing pro-Beijing tendencies,

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(Tow, 2005). A few days later Howard responded that 'nobody can doubt that Australia is a loyal ally of the United States', and reverted to the orthodox interpretation of ANZUS as being invoked in an attack on ANZUS forces (McDowall, 2009).

[23] Interview: 6

harmonisation of the China policy was believed by many strategists to be a chief strategic imperative for the TSD (White, 2007).

To Beijing's disappointment, Australia took an active part in initiating the first ministerial-level U.S.-Australia-Japan Trilateral Strategic Dialogue (TSD) process in 2006,[24] and concluded a bilateral defence and security cooperation pact with Japan a year later. To many Chinese commentators, the TSD and Australia-Japan security agreement would encourage the emergence of an 'Asian NATO', which would be perceived by Beijing as a serious deterioration in China's regional security environment. Yet by voicing a different view on China and reiterating that it would be a mistake to seek to contain China shortly before the March 2006 TSD meeting in Canberra, the Howard government told Washington, Tokyo and Beijing that the TSD process was not and should not be designed against China. A month later Canberra signed nuclear energy cooperation agreements with Beijing, paving the way for the sale of Australian uranium ore to China. This was an act which surely pleased China and caused worry for the United States. China was aware of its incapacity to forestall the TSD process. Accepting the fact that Australia was the most moderate of the three TSD countries, Beijing recognised that Australia was playing a role different from those of the other two dialogue members, and lowered its official critique of Canberra compared with the years of 1996 and 2001[25] (Hou, 2008).

The shift in the Australian position vis-à-vis America and China was strategically viable only in the context of the Sino-American entente in the post-9/11 period, when both Washington and Beijing were displaying

[24] The Trilateral Strategic Dialogue was elevated from senior official level to ministerial level in 2006, largely driven by perceptions in Washington of Australia's strategic drift towards China that the United States found worrying (White, 2007).

[25]The first ministerial meeting of the Trilateral Strategic Dialogue in 2006 was an unsatisfactory, if not a disappointing experience for America. The meeting reflected, more than anything else, U.S. concerns about China's growing power and influence, and the expectation that Australia could be brought back into line with American thinking on China and become more vocal in expressing concerns about China's rise. On the issue of how best to respond to the rise of China, American and Japanese interests and policies may have been converging, but Australia's policy was heading in a different direction. Having become more wary of offending Beijing, Canberra wanted to avoid anything that might look to Beijing like containment and argued that alliance coordination should not be specifically targeted at China. The Trilateral Strategic Dialogue thus had done nothing to bring Australia into line with its interlocutors. America's failure only went to show how serious the problem had become: if a country as close and dependent on the United States as Australia was not prepared to join America in taking a frosty approach to China, the prospect of building support among others in Asia was doomed (White, 2007).

greater strategic tolerance towards Australia. Canberra enjoyed considerable leeway as it was able to express different opinions to both great powers without damaging its economic ties with China and its security alliance with the United States. Howard refused to accept the notion that Australia had to make a choice between its history and geography. In retrospect, Howard managed to avoid the dilemma largely because of the permissive strategic environment then in place had allowed him to embark on a delicate balancing act between Beijing and Washington, without inviting hostility and suspicion from both capitals.

The Howard government was also not enthused by the quadrilateral proposal when it was first floated in 2007 by Japanese Prime Minister Shinzo Abe.[26] Australia was persuaded by the United States to take part in the first Quadrilateral Initiative gathering with Japan, the United States and India held on the sidelines of the ASEAN Regional Forum Ministerial Meeting in Manila in May 2007. Howard was wary of getting involved with the quadrilateral grouping for fear of arousing Chinese suspicion and antagonising Beijing. Beijing had already taken a dim view of Canberra's U.S.-backed bilateral and trilateral defence ties with Japan. From the Chinese perspective, such a quadrilateral initiative was apparently directed at China, and her relations with Japan and India were not cordial. Having grave misgivings about Abe's notions of 'value diplomacy' and an 'arc of freedom and prosperity' stretching across Asia, Beijing viewed the four-power meeting as symbolising a nascent geopolitical line-up of maritime democracies against China, and sent protests to the four governments. Despite the precarious strategic situation in the Western Pacific, Asian leaders (probably with the exception of the Japanese) were playing down the risk that contrasting regime characteristics would constitute the main geopolitical dividing line, potentially pitting a China-led axis of autocracies against an alliance of democracies. In this context, Australia's growing wariness may have been no different from India's.[27]

By 2006, the good mood and warm atmosphere of the China-Australia bilateral relationship was apparent. This was in a stark contrast with the acrimony and hostility that characterised the initial phase of the bilateral ties in 1996 and the frequent disputes during much of the pre-9/11 reconciliation period. During his meeting with Chinese Premier Wen Jiabao in Canberra in April 2006, Australian Prime Minister

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[26] Interview: 49

[27] Shortly after Kevin Rudd came to power, Australia unilaterally withdrew from the Quadrilateral Initiative in February 2008.

Howard acknowledged that of all the major relationships that Australia had with other countries, none had been more completely transformed than the relationship with China over the last ten years: ‘Now I don’t seek to invoke language such as special relationships and so forth, but I simply make the point that the transformation of the relationship with China has been remarkable’[28] (McDowall, 2009).

Given the diplomatic warmth and Australia’s perceived importance as a regional power in the Asia Pacific region (not to mention its salience as one of China’s top resource suppliers), the relationship with Australia apparently deserved the characterisation of a ‘strategic partnership’ from the Chinese standpoint. After all, China had established various kinds of ‘strategic relations’ and ‘partnerships’ with many other regional powers. It was curious, if not somewhat abnormal, that the perceived importance of this relationship was yet to be recognised and affirmed in China’s official characterisation. The Sino-Australian relationship still remained at the level of ‘a cooperative relationship’ throughout the decade since it was first officially recognised as such in 1999.[29]

In the light of the geopolitical flux in the Asia-Pacific strategic arena, Chinese analysts viewed Australia as a significant player in the regional balance of power. Australia’s strategic relevance to China derived from its strengthened alliance with the United States since the mid-1990s and tightened defence ties with Japan in the mid-2000s. Australia also upgraded its strategic cooperation with South Korea, cemented partnership with ASEAN, and established strategic partnership with India. In a number of fluid power configurations involving strategic triangles and strategic squares in the region, Australia was courted by various powers, including the United States, Japan, India, South Korea, and ASEAN, as a valuable strategic partner in the precarious power dynamics of the region (Zhai September 4, 2007). Given Australia’s growing salience in regional strategic diplomacy, Beijing’s intention around the mid-2000s was

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[28] Howard’s personal diplomacy had advanced from the low point of his office—a crisis meeting with Chinese President Jiang Zemin in Manila in 1996—to the intimate honour of ‘jogging diplomacy’ with Chinese Premier Wen Jiabao on the banks of Lake Burley Griffin, Canberra in April 2006. As the Chinese embassy noted, Premier Wen ‘was the first foreign leader he (Howard) walked with in the early morning and that it was a major breakthrough in Australia–China relations’ (McDowall, 2009).

[29] Both sides agreed to characterise the relationship as a ‘comprehensive long-term stable and healthy cooperative relationship towards the 21st century’ in 1999 during President Jiang’s visit to Australia. During Premier Wen’s visit to Australia in 2006, the relationship was reaffirmed as a ‘comprehensive cooperative relations with mutual benefit and win-win results for the 21st century’.

to give a further boost to the political ties with Canberra.[30] The strategic significance of the bilateral relations was often emphasised by Chinese officials and leaders.[31] Indeed, China's leaders had on a number of occasions hinted at the possibility of further cooperation with Australia along the direction of working towards a strategic partnership. China made it clear that the bilateral ties were of strategic importance, and the Beijing leadership repeatedly stressed China's commitment to 'unswervingly handle and develop the relationship between the two countries from a long-term and strategic perspective' (*changyuan jiaodu he zhanlue gaodu*)[32] (Hu 2003). Chinese analysts admitted that China ultimately was seeking to upgrade the bilateral relationship to a strategic partnership.[33] Arguably, the decision to establish the annual bilateral Strategic Dialogue between Canberra and Beijing was largely a Chinese initiative to facilitate bilateral cooperation over bilateral and regional strategic issues. This Chinese initiative was also made in response to the upgrading of the Australia-U.S.-Japan Trilateral Strategic/Security Dialogue to ministerial level in 2006.

The statement made by the Australian Foreign Minister in Beijing in 2004 was revealing:

> *With Premier Wen we agreed that Australia and China would build up a bilateral strategic relationship, that we would strengthen our economic relationship and we would work together closely on Asia Pacific issues, be they economic or security issues…Diplomatic relations between countries evolve, you know, rather than change by gigantic steps—and what we are seeing through what Premier Wen said to me about building a strategic relationship between Australia and China is a significant development, in that I think China has seen Australia in years gone by as an important economic partner and a less important political and strategic*

[30] Interview: 27

[31] Australia was an important target audience for China's 'New Security Concept' diplomacy and reassurance policy at multilateral regional forums. China also engaged in active military diplomacy with Australia as an integral part of this security strategy. Australia was ranked among China's most important partners in regular bilateral dialogues on defence, arms control and non-proliferation issues; and it was also one of the few countries with which China actively pursued bilateral military exchanges.

[32] This was interpreted by the Australian administration as a tacit Chinese invitation to build a strategic relationship with Australia that would move beyond trading ties to substantive collaboration on security and political issues in the Asia-Pacific region.

[33] Interviews: 19, 27, 66

*partner, and I think now there is a recognition by the Chinese leadership of the significant role that Australia plays in the region…I think we are seeing the evolution of a much stronger and much fuller relationship which encompasses many challenges of the Asia-Pacific region of the political and security nature, not just of an economic nature.* (McDowall, 2009)

This was a ground-breaking statement because by accepting Wen's overture of a strategic relationship, Downer was changing Canberra's official line, according to which Australia's relationship with China still remained a 'strategic economic relationship' (rather than a strategic relationship of an all-round type). It was argued that there had been a steady evolution in Australia's official characterisation of the bilateral relationship, from an 'economic relationship' (used in 1996), to an 'economic relationship with strategic significance' (used in 1997), to a 'strategic economic relationship' (used in 2003). From the vantage point of this gradual evolution, Downer's remark was interpreted as indicating that Australia and China had established an explicit 'strategic relationship' (or a 'strategic partnership'), thus completing the transition (McDowall, 2009)

Downer's statement, however, was widely criticised at home. The ensuing controversy surrounding this new 'strategic partnership' forced the Howard government to retreat from publicly acknowledging the 'strategic relationship'. The Australians were arguably more serious about the potential policy connotations that might be implied by the term 'strategic', not least because their understanding of the commitment to a formal strategic partnership/relationship was not exactly the same as the Chinese. The Australians had cautioned themselves against developing formal strategic ties with China lest any policy confusion or suspicion jeopardise the country's alliance with the United States, which kept a close watch on how Australia approached its Chinese ties. In fact, before the term 'strategic economic relationship' was used in the 2003 foreign policy white paper, there was a tense debate within the Howard government about the choice of word: the alliance-focused conservatives wanted to avoid anything that was 'strategic' with China, while others advocated that Australia's economic future lay with China and it was imperative to forge a strategic relationship with the rising power.[34]

[34] Interviews: 54, 66

In his official visit to Australia in 2006, Chinese Premier Wen allegedly proposed again of upgrading the relationship to strategic partnership during his meeting with Prime Minister Howard. Premier Wen's proposal was reportedly declined by Howard (Boxun May 14, 2010). This was understandable from the Australian perspective. The Chinese Premier's visit came not long after the first ministerial Trilateral Strategic Dialogue was held, where considerable differences over strategic interpretations of China's rise were evident between Australia on the one hand and America and Japan on the other; Canberra was extremely sensitive to the U.S. attitude and had considerable qualms about the necessity of moving strategically too close to China under the circumstances of the time. Howard himself had serious reservations about the idea of a strategic partnership with Beijing, not least because there was no added incentive or strategic imperative for Canberra to upgrade its political ties with Beijing in this way.[35] In the end, diplomatic pragmatism prevailed. After the controversy over Downer's Beijing remark, Canberra refrained from making overt references to a 'strategic relationship' (McDowall, 2009), although warm overtures towards China continued.

Beijing understood Canberra's position, and was by and large content with the pragmatism and 'benign ambiguity' (vis-à-vis China and the United States, especially on Australia's role in conflict over Taiwan) displayed in Australia's changing posture. The Chinese foreign ministry spokesperson's remark at a regular press conference on 27 November 2007 provided a revealing insight into China's take on Howard's China policy. When asked to comment on the prospects for Sino-Australian relations under the newly elected Australian Prime Minister, Kevin Rudd, in addition to expressing congratulations and good wishes for further growth of the bilateral relations, Qin Gang referred to John Howard by stating:

> *I would like to mention former Prime Minister Howard here. In his term, the Australian government and Mr Howard himself attached great importance to the relationship with China and made positive effects for the development, which we appreciate. We are satisfied with the development of Sino-Australia relationship, and have full confidence in its broad prospect.* (Hou, 2008)

[35] Interview: 66

## 2.4 A Rupturing Sino-Australian Strategic Relationship since 2008

Howard's approach to managing ties with China was effective as Canberra successfully decoupled its relationship with Beijing from its alliance relationship with the United States. By nurturing rapidly growing economic ties with China and welcoming its rise, while acting as a loyal ally of America in counterterrorism and the wars in the Middle East, Canberra managed to move closer to both Washington and Beijing. The Howard government was pragmatic enough to avoid becoming overly enthusiastic about building a too-intimate strategic relationship with Beijing; and neither did it allow pressure from the alliance to interfere with Australia's important economic partnership and growing political ties with China. The steady improvement in strategic relations between China and Australia during the post-9/11 period however failed to persist after 2008.

Howard's successor failed to maintain the positive momentum. Fluent in Chinese, Kevin Rudd was more ambitious in elevating ties with China to a higher political tier. Beijing initially welcomed Rudd's early political enthusiasm for increased ties with China and was almost delighted by Rudd's diplomatic fixation on improving relations, but were somewhat put off by his push for a 'true friendship' (*zhengyou*) (Zhang, 2012). Rudd's initiative for a new type of relationship with China based on the '*zhengyou*' model focused on the Labour Prime Minister's idealistic agenda on human rights and an expectation of genuine equality. This arguably would require Chinese acceptance of Australia's candid criticisms of the Chinese government and even Chinese acquiescence on what could be deemed foreign interference in China's internal affairs, as well as challenges to China's core interests. Apparently Kevin Rudd's idealistic aspirations to make Australia a 'critical friend' to China caused great annoyance amongst the Chinese leadership, despite Rudd's other friendly diplomatic overtures. Beijing managed keep to its displeasure at a relatively low-profile in public to avoid explicit embarrassment; but Chinese protests were conveyed through covert diplomatic channels with unequivocal messages to express Chinese disappointment and objections to what they saw as Australian interference in China's internal affairs.

In retrospect, this early hurdle in the relationship between the Rudd government and Beijing was only the first in a series of events that quickly worked to derail the bilateral relations during the two years between 2008 and 2009. However, the more significant factors that had brought the Sino-Australian entente to an abrupt halt came from the changes in international politics and regional strategic circumstances towards the end of the 2010s. Up until 2008, Rudd and Howard alike perceived China's rise and Beijing's international behaviour in a positive light; but when the financial and economic crisis broke out, it triggered changes in global and regional strategic circumstances that completely transformed the pre-2008 situation.

During its final years, the Howard government did consider the potential negative strategic implications of China's rising hard power; but these concerns at the time remained more abstract than real. They were not reflected in the main trends of Howard's China diplomacy, nor did they characterise the distinctly positive mood of the post-9/11 Howard years. Concerns about the Chinese threat neither featured in official discourse nor resonated with the dominant mood in the region. In the post-9/11 context, Beijing and Washington were on good terms with each other. Beijing's willingness to seek Sino-American strategic stability, Chinese cooperation in counterterrorism and other security issues, as well as China's posture of strategic self-restraint were understood and appreciated by the Bush administration, which indulged in the global War on Terror and the Middle East affairs with prolonged strategic neglect of East Asia.

Before more cracks appeared in the bilateral relations, the Rudd government at the time also shared Howard's general sentiment, despite concerns over China's human rights record. Rudd recognised that the generally benign regional strategic circumstances presented a window of opportunity for everyone, though he soberly observed that it was uncertain how long the strategic stability would last. He pressed Beijing and Washington to seize the historic opportunity to build a closer partnership and advocated a 'bridge' role for Australia between the two great powers (Rudd April 20, 2007; Rudd March 31, 2008). Not long after Rudd came to power, that 'window of strategic opportunity', as perceived by the new Labour Prime Minister, began to close. China gradually began to project its power and to throw its weight around in the region. From the outset of his presidency, President Barack Obama became determined to elevate East Asia in U.S. global security and strategic priorities. However, the early period of the new administration's East Asia strategy was not so much fixated on containing Chinese expansionism, as it was attempting to make up for the benign neglect of the region which characterised the previous administration's focus on the Middle East. Only after unsuccessful initial attempts to make diplomatic overtures to Beijing during much of 2009, did the new American administration decide to take a harder line on China. President Obama's initial diplomatic overtures to Beijing were met with Chinese arrogance and failed to secure a common understanding with the Chinese leaders. As Beijing's new assertive and expansionist strategic posture became more apparent, the Obama administration eventually began to centre its Asian 'pivot'/re-balancing strategy on countering Chinese assertiveness and growing expansionist tendencies. China-U.S. strategic tensions surged accordingly and their strategic competition in the region and beyond intensified as a result

Howard had been able to decouple the relationship with China from the alliance ties (Qiu & Huang June 27, 2006). By 2008 and 2009, Rudd no longer had that luxury. Even if the Labour government wanted to maintain a friendly posture towards Beijing and wished to continue to proceed with a decoupling strategy, the rising strategic competition between China and America in the post-2008 period had already begun to generate huge pressures from the alliance that would pull Canberra and Beijing apart. More importantly, it was the dramatic change in Australia's strategic perception of Chinese behaviour that altered Canberra's approach towards its strategic relationship with Beijing. Both China and Australia coped very well in the global financial and economic crisis and China's growth and demand were a major reason why Australia did not suffer recession. However, China's increasing economic importance was growing in parallel with the perceived threat posed by China's new behaviour. If anything, the former was being completely overshadowed by a looming fear of Chinese domination in Canberra's evolving strategic perceptions.

### 2.4.1 The Changing Face of Chinese Foreign Policy

As part of the profound strategic consequences of the 2008-2009 global financial and economic crisis, China began to project its growing power. The Chinese leadership began to believe that the global power configuration had changed in China's favour (Wang, 2010); from the Chinese perspective, the end of America's unipolar status had arrived. The relative decline of the West and the rise of the emerging powers from the developing world in Asia and elsewhere, were the new power realities. Having emerged as the world's second largest economy, China was leading this global power shift and gradually narrowing the disparity in hard power with the United States, first and foremost measured by the size and growth rate of GDP.

Also significant was the Chinese perception that the strength of China's development model had been vindicated by the resilience of the Chinese economy during the economic crisis. By contrast, Washington was financially crippled, fiscally ill and bogged down in a morass of strategic misadventures abroad and foreign policy quagmires. A 'success mentality' had become pervasive among the Chinese elite. The idea emerged that China no longer needed to look to the West for inspiration and guidance: the country had graduated from being a student and imitator of the developed world to having the capacity to chart its own path toward modernisation; China had been doing things its own way and achieved great success; it would walk tall and stick with its own way of doing things; already an economic great power, the country no longer had the imperative to learn from others because its development model had so far proved equal if not superior.[36] This new thinking marked an emerging competition of (development/economic) models between China and the United States, whereby the Chinese had come to develop a rather bold and triumphalist outlook and more assertive posture towards the United States in particular and the West in general.

This buoyant sense of triumphalism and the perceived U.S. decline emboldened China to redefine its terms of engagement with America and others. This changing mentality translated into China increasingly projecting her assertiveness,[37] And becoming more self-righteous in pursuing her national interests. The Chinese expected other states to offer realistic and sober assessments of the new power reality and be prepared to deal with a new type of relationship with China, including paying more respect to China's interests.[38] Indeed, protecting China's core interests became more important than preserving inter-state friendships. Changes in figures by themselves did not really tell the whole story; the Chinese themselves understood clearly and recognised the shortcomings of power comparisons based on GDP figures alone. However, the psychological environment had already changed along with the perceived power shift; it was this changing mentality that had been consequential in redefining China's external behaviour.[39]

[36] Source: Wang Jisi's public lecture on Chinese foreign policy in Nankai University, November, 2010, Tianjin.

[37] Ibid.

[38] Ibid.

[39] Ibid.

China's rising power over the past ten years and the changing strategic circumstances were gradually undermining both the material and ideological basis of Deng Xiaoping's foreign policy thinking conceived two decades prior. The global financial and economic crisis had greatly accelerated this process and increased pressure for a paradigm shift in foreign policy thinking. As China sought to chart a new foreign strategy commensurate with its newfound power and expanding interests, domestic support for Deng's foreign policy paradigm was rapidly waning rapidly amongst the Chinese elite and the general populace. The strategy of 'biding one's time and hiding one's capabilities' (*taoguang yanghui*), once the keynote of China's international policy, had come under sustained attack at home and become virtually impossible to gain universal support (Wang, 2011b).

Towards the end of the 2000s, the search for stability with the United States no longer dictated Beijing's approach towards Washington. America still remained the centrepiece of Chinese diplomacy, and by and large, the Chinese leadership still favoured a good and stable relationship with America and could not afford to allow conflicts with the superpower to spiral out of control.[40] However, Beijing had begun to demand a more equal relationship and expected Washington to adjust its behaviour towards China in accordance with the new power realities;[41] thus the diplomatic slogan for a 'new type of great power relationship' was championed by the Beijing leadership. Accepting the new terms of engagement with China on a more equal footing was seen as an essential prerequisite for a stable U.S.-China relationship (Yang July 9, 2010). Unless Washington adopted this new mindset and abandoned its 'arrogant and hostile' behaviour and attitude towards Beijing in accordance with the requirements of the new power parity, the two great powers would be bound to have a rocky relationship. Without reciprocal concessions from Washington, Beijing would not be as submissive and ready to accommodate U.S. interests as it had been in the past; consequently, the two nations would embark on a collision course.

Beginning in 2008, rising assertiveness and an emerging offensive posture thus featured prominently in China's policy towards the U.S. over a wide range of issues. There has been considerably more vigorous Chinese opposition to U.S. arms sales to Taiwan since 2009. Beijing also adopted a more offensive

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[40] Interviews: 3, 82

[41] Source: Wang Jisi's public lecture on Chinese foreign policy in Nankai University, November 2010, Tianjin.

rhetorical position in criticising America’s role in the financial crisis and castigating U.S. fiscal and monetary policies. The Chinese even stepped up efforts to challenge America’s global financial hegemony and more actively promoted the reform of the global financial and economic order (Zhou, 2009).

Most notably, the Chinese also intensified their efforts to undermine U.S. strategic/military hegemony. This partly manifested in the increasing hawkishness of the Chinese military that was fixated on U.S. military strength. Beijing’s offensive posture towards Washington manifested in a new defence orientation that increasingly sought to challenge U.S. military dominance in the Western Pacific. The People’s Liberation Army (PLA) had become much more assertive in opposing what the Chinese saw as ‘provocative’ high-intensity oppressive offshore maritime surveillance activities along Chinese coast by the U.S. Navy. Beijing demonstrated its growing determination to seek sea power by developing its ‘Blue-Water Navy’ and maritime-denial capabilities. Since 2008, the PLA Navy has increasingly carried out unilateral force projection manoeuvres in and beyond the East China Sea; and there was a significantly increase in incidences of Chinese submarines and naval fleets making ‘provocative’ appearance in waters close to Okinawa and beyond the first island chain. The mounting tensions and intensifying rivalries between the PLA navy and the American and Japanese naval forces considerably increased the risk of violent sea incidents; as a result, maritime conflicts and misfires at sea have come to be seen as a real danger.

With years of double-digit growth in defence spending, Beijing has been able to devote huge resources to catch up with Washington and gradually close the military power gap between the PLA and its U.S. counterpart. Having developed formidable maritime-denial and strategic delivery capabilities, the PLA displayed a growing tendency to flex its muscle by showing off its high-tech weaponry systems and bolstering its military deterrence. The competition also went beyond the strategic theatre of the Western Pacific and conventional arms races. The arms race extended to non-conventional and asymmetrical warfare as both countries strived to build up their respective outer space, cyber warfare and nuclear capabilities. While China’s defence planning, weapons programmes and military strategy were said to have been geared towards a military contingency over the Taiwan Strait against U.S. forces, China’s military modernisation in recent years were thought to reflect growing Chinese strategic ambitions that reached beyond the Taiwan scenario.[42]

With its growing security needs and expanding strategic ambitions, an ascendant China also started to test the limits of the regional influence it garnered during its effective charm offensive since the end of the 1990s (Bower, 2011). Assertiveness also featured prominently in Beijing's posture towards its regional neighbours since 2008. This new stance may not have been hegemonic, but it was designed to expand the area of Chinese influence to meet China's growing security needs and great power ambitions. Beginning in 2008, China began to project assertiveness and to adopt an offensive orientation in asserting sovereignty in maritime disputes. The intensification of maritime tensions in recent years was caused first and foremost by deliberate Chinese attempts to employ new tactics and an increasingly hard-nosed approach in maritime disputes, in addition to being partly driven by China's growing concerns for resource security. However, the country's changing foreign policy outlook was arguably the most consequential factor in leading to more forceful and intensified efforts to preserve Chinese sovereign interests as Beijing sought to take advantage of China's rising power and exploit U.S. weakness.

Beijing tested its power by declaring the South China Sea China's 'core interests' and substantially stepped up efforts to strengthen and expand Chinese presence and effective control in the disputed waters of the South China Sea. Assertive Chinese manoeuvres were carried out to undermine the territorial claims of other rival claimants and the legitimacy of foreign occupation of the disputed islands and reefs. Since 2008, there has been a dramatic increase in the incidence of the dispatch of Chinese law enforcement vessels (mainly the Chinese fisheries administration and marine surveillance vessels) to the disputed waters to assert sovereignty and to stop alleged encroachments on Chinese sovereignty by Vietnamese and Filipino vessels in those areas, through using direct and forceful physical disruptions. Beijing also rapidly enlarged its maritime law enforcement fleets, many of which had come close to becoming paramilitary forces. A modern naval submarine base was built on Hainan Island to extend the projection of the PLA's capabilities into in the South China Sea. Battlefield simulation and naval exercises aimed at seizing control of occupied islands were conducted with growing frequency (Jia, 2012). Towards the end of the 2000s, Beijing also began to take on Tokyo over the Diaoyu/Senkaku Islands in the East

[42] Interview: 75

China Sea. Chinese warships, fighters, and civilian vessels (including fishery patrol boats, maritime surveillance ships, and scientific expedition vessels and fishing boats) were dispatched to the disputed waters around the Senkaku/Diaoyu Islands to assert territorial rights. Military confrontation and direct contact between the Chinese fighters, naval warships and civilian surveillance vessels with their Japanese counterparts became dangerously common in those waters.

## 2.4.2 Canberra's Hardening Strategic Attitude towards Beijing

Beijing's growing assertiveness triggered fears of Chinese domination and aroused apprehension about the prospects for U.S. strategic primacy in East Asia. Australia's strategic anxiety surged with an increasingly domineering Chinese posture that led to rising Sino-American military competition, intensified international rivalries over maritime disputes, heightened regional security crises, and strategic tensions across the region. As the East Asian security environment slipped into security competition and strategic rivalry, Australia's perceptions of China's rise and growing military power began to fundamentally change. From a defence point of view, the Australian policymakers were increasingly alarmed by the PLA's rapid modernisation. Their concern was that over time China could get into a military position where there would be a distinct shift in the balance of power that could be detrimental to Australia's interests.[43]

Apart from the deteriorating regional strategic environment set off by China's new posture and growing hard power, Australia's hardening attitude towards China was further reinforced by the events that took place in the bilateral context. The period between 2008 and 2009 marked a turning point in the relationship. The good faith and high expectations that existed on both sides at the beginning of the year were slowly eroded by events such as Rudd's pointed remarks about Tibet which were aired in Beijing, the emotional political rows over the security arrangement for the Olympic torch relay in Australia, and the tightening of Australia's investment regime against Chinese capital.[44] The political relationship reached its lowest point in the following year as a series of unfortunate incidents sustained and further intensified the bilateral tensions and resulted in months of diplomatic confrontation and stalemate, if not

[43] Interview: 75

[44] Interviews: 73, 77

crises. The spy scandal involving the then Australian Defence Minister and a Chinese businesswoman, the publication of the Labour government's 'anti-China' Defence White Paper; the collapse of the Rio-Chinalco deal; the arrest of Rio Tinto employees including the Chinese-Australian manager Stern Hu by China's state security service on spying charges; the heated diplomatic quarrels over exiled Uighur leader Rebiya Kadeer's visit to Australia. Each of these unfortunate developments dealt a heavy blow to the fragile and precarious bilateral ties, thereby completely removing any residual mutual trust and goodwill between the two countries' governments. The signing of the 2009 Sino-Australian Joint Declaration in September marked a diplomatic truce (Department of Foreign Affairs and Trade October 30, 2009). As the two governments reached a kind of *modus vivendi*, both sides pledged to respect their respective core interests and move the relationship forward by setting aside their political differences. This helped ease the political deadlock because both sides understood that the relationship was too important to be left adrift; but it failed to revitalise the political ties, which were further damaged by the 2010 WikiLeaks revelations concerning Kevin Rudd's hard-nosed realist views on China and the hawkish advice on China he provided to the Americans.[45] From the Australian perspective, the Chinese had become increasingly arrogant and supercilious in their bilateral dealings. Arguably, given the hurdles that had emerged in her relationship with China in 2008 and 2009, Australia got a foretaste of China's domineering assertiveness.[46]

Consequently, the surging strategic anxiety about China formed the cornerstone of Australia's 2009 defence white paper (Defence May 2, 2009). The potential adverse consequences of China's rising hard power and the beginning of U.S. decline, the security ramifications of the global power shift and the alarming long-term strategic consequences of the economic crisis, all featured prominently in the white paper's assessment of Australia's strategic environment. Each of these elements was overshadowed, however, by the looming Chinese threat. The explicit expressions of doubt concerning the prospects for U.S. strategic primacy were unprecedented in Australia's strategic documents and official enunciation of the country's strategic outlook. The white paper thus offered a rather pessimistic and alarmist outlook on the Asian-Pacific strategic scene, which it predicted would be characterised by escalating power rivalry, increasing strategic competition, growing risks of strategic shocks, and great power wars, as well as

[45] Interview: 27

[46] Interview: 77

intensified regional military build-up and arms race.

## 2.5 New Alliance Dynamics: Preparing for China's Rise

The alliance dynamic between Australia and the United States also underwent a significant transition in the post-financial crisis era. At the core of this marked shift was a shared concern over China. Alliance discord over China during the Howard years was carried over into the first year of the new Labour government after the 2007 Australian general election. The prolonged effect of this particular alliance legacy had simultaneously reinforced and been further accentuated by low trust between the Bush administration and the new Labour government (Fullilove, 2008). Rudd did not inherit the kind of personal trust and intimacy his predecessor had achieved with the American President. More importantly there was no genuine convergence of strategic priorities between the Bush administration and the new Labour government in 2008. While the security strategy of the U.S. administration remained fixated on counterterrorism, the Middle East and the two ongoing wars in Iraq and Afghanistan, the Rudd government did not see Australia's immediate and most vital strategic interest in that part of the world. The new government even reduced Australian commitment to the coalition efforts in Iraq by withdrawing Australian combat troops from that country (AUSMIN February 23, 2008a, 2008b)

On the other hand, Rudd was absorbed by East Asia. The new Australian government's foreign policy preoccupation with Asia led to an elevated regional agenda; and China was at the centre of this move. At least for the first half of 2008, Rudd wanted to promote Canberra's engagement with Beijing, both economically and politically. As the Rudd government began to embrace its ambitious China project, the elevated centrality of China in Australian diplomacy and Rudd's supposedly pro-China disposition could not but exacerbate the embedded unease and mistrust that somewhat characterised the fragile rapport between the Australian and U.S. governments in 2008 (Fullilove, 2008; AUSMIN February 23, 2008a, 2008b). By the second half of 2008, Rudd had come to develop a more cautious attitude in his China agenda as his strategic perception of Beijing was beginning to be changed by events and his experience of dealing with the rising power of China. However, the relationship with the U.S. administration did not really get back on track until the election of Barack Obama in 2009.

The new U.S. administration's global security posture diminished the importance of allied cooperation in the War on Terror on which the close allied partnership had been built during the Howard-Bush years.

Australia's increasing economic dependence on China, the Labour government's traditional pro-Asia foreign policy outlook, Canberra's increasing accommodative approach towards China during the Howard years, and Kevin Rudd's ostensibly ambitious China policy, all made Washington worried about Canberra's future strategic orientation and even loyalty to the alliance. Whether the new leaders of both countries could rebuild the kind of personal trust and intimacy Howard and Bush had shared was an open question for the new Australian and American governments (Fullilove, 2008).

The Labour government was eager to continue the close strategic partnership with Washington and regain its alliance credentials. Anxious to give the alliance new momentum and reaffirm Australia's loyalty, Canberra attempted to rebuild alliance trust by looking for new areas of strategic cooperation with Washington; i.e., Australia was searching for new ways to be useful to the United States. Given Canberra's growing anxiety about Beijing, it became all the more imperative to reassure the Western world and the United States in particular about Australia's deep and special affinity to the West and the American alliance. Thus, since taking office in 2008, the Labour government endeavoured to adjust Australia's defence policy and security posture to meet its ally's expectation, as the new American administration was determined to prepare the United States for the arrival of a 'Pacific Century' (Clinton November, 2011).

Whilst shifting its foreign policy priority away from counterterrorism, non-proliferation and the war in Iraq, the Obama administration pursued a proactive East Asian strategy to preserve U.S. hegemonic position in the region. The ANZUS alliance imperatives changed accordingly with this American policy shift. On the one hand, Canberra was compelled to pursue greater allied strategic cooperation with Washington in East Asia and on the question of China. But more importantly, the Labour government of Australia shared the Obama's administration's growing concern over China's behaviour and the alarming shifts in the regional balance of power. There was genuine convergence of foreign policy priorities between the two new governments in the East Asian theatre. By the end of 2009, the Labour government had also proved its credibility in the alliance by deepening Australia's commitment to the Afghan endeavour, as Australia became the largest military contributor to the coalition amongst America's non-NATO partners; Canberra also enhanced Australian civilian efforts in the post-conflict state-building project in Iraq (AUSMIN April 9, 2009a, 2009b).

In the first year of the Obama administration, the thrust of America's East Asia policy rhetoric was defined by not so much an all-out diplomatic and strategic offensive against China's expansionist behaviour in the region, as a long-needed effort to redress years of strategic neglect of the region by the Bush administration. However, by the time the Obama administration experienced its failed overtures to Beijing and witnessed Beijing's emerging assertiveness in 2009, Washington began to turn its gaze towards China by focusing U.S. Pacific strategy on managing China's rise and countering Beijing's growing ambition in the region. Given Washington's increasing fixation with China's rise in Asia, a *de facto* containment strategy aimed at China came to define America's pivot/re-balance in Asia. Since 2010, the renewed policy emphasis on Asia and the Pacific region reflected the Obama administration's growing anxiety over China's strategic intentions. These anxieties compelled the U.S. administration to reassert its influence in regional security affairs, strengthen regional alliances, expand strategic partnerships with the Asian powers that shared America's strategic concern about China, and enhanced military deployments in the Western Pacific.

Given the looming prospect of intensified U.S.-China strategic competition in the Pacific and Asia, Washington increasingly looked to its allies for greater sharing of the burden. America's Asian allies were expected to play a more active role and enhance policy harmonisation with the United States in tackling the challenge of China's rise. As an important part of America's pivot/re-balancing efforts, Canberra was an expected and willing partner. The execution of a more vigorous U.S. Asian strategy largely centred on China therefore coincided with the beginning of the Rudd government's policy realignment. With a shared concern over Chinese and U.S. standing in the region, Canberra and Washington once again forged a close intellectual intimacy, and the alliance agenda was therefore transformed accordingly. By the end of 2009 and the beginning of 2010, the allied priorities were shifting to the wider Asia-Pacific region rather than focusing on counterterrorism and the Middle East affairs. The purpose of the alliance was redefined as Washington and Canberra began to prepare the alliance for the re-balancing efforts against China's growing ambitions and aggressive behaviour (AUSMIN November 8, 2010a, 2010b). Alliance intimacy and trust were quickly regained at a time of great geopolitical change and power shifts. That Australia was the only Western democracy and Anglo-Saxon ally in this part of the globe made the alliance all the more valuable. This was arguably the first time ever in the alliance's history that Australia was deemed a strategic asset by the United States mainly for the purpose of containing China. The alliance's discord over China, which had become a point of division for the alliance's relations during the later years of the Howard era, had completely disappeared. By the end of the decade, the Labour government and its leaders had demonstrated their loyalty and credentials to the alliance, rebuilt allied trust and proved themselves to be useful partners in Washington's Asia pivot/re-balance strategy.

Since the onset of the global financial crisis, there was a burgeoning anxiety over U.S. decline in Australia; and the prospect of America's strategic retrenchment and disengagement from East Asia had increasingly become a worry. By 2009, Canberra was largely no longer worried about American neglect of East Asia and the Pacific. Nevertheless, worries remained acute in 2009 and 2010 about continued distractions of the unfinished businesses in the Middle East and the constraints imposed by the continued uncertain legacies of the protracted military engagements in Iraq and Afghanistan (and increasingly in Pakistan as well) on the Obama administration's ability to focus on East Asia. The new concern was whether Washington still had the will and capability to preserve U.S. strategic supremacy and honour its security commitments in the face of protracted domestic economic and political weaknesses and growing challenges posed by an ambitious China. By the end of the 2000s, the prolonged war in Afghanistan and the tremendous budgetary pressure raised doubts about whether the United States would have the resolve and resources to remain committed to Asian security and regional strategic stability. Australia's fears were further reinforced by America's prolonged economic difficulties, protracted political infighting due to partisan division, and the immediate prospect of massive cuts in U.S. defence budget, at a time when the sense of Australian dependence on U.S. strategic primacy to underpin East Asian stability had never been more acute.

Like many other East Asian countries, Australia was worried about whether the United States could effectively check China's rise and her strategic expansion at a time when domestic economic crises and political stalemate seemed to have eroded U.S. strategic assets and undermined America's ability to project its power, not to mention the protracted security situations in the greater Middle East that continued to preoccupy the Obama administration. To Australian eyes, the challenges facing U.S. statecraft were formidable. The Australian leadership understood the budgetary pressure on the U.S. government but cautioned against defence budget cuts that would cripple America's ability to maintain its strategic presence in the Western Pacific.

The Labour government was therefore keen to urge the Obama administration to step up its engagement in East Asia. Australia's message was that the United States should shift the focus of its global strategy to East Asia and the Asia-Pacific sooner rather than later. Canberra urged Washington to be bold and stay closely involved in the Asia-Pacific in order to take on Beijing decisively by deterring and resisting Chinese expansionism. The Australian leaders recognised that the United States would always have vital interests in the Middle East, but nevertheless pressed their U.S. counterparts to focus more on East Asia. As both Kevin Rudd and Julie Gillard put it, American policy attention needed to fully embrace the deep changes underway across Asia, the Pacific and the Indian Oceans; and it was imperative to intensify focus on the Asia-Pacific and the Indian Ocean, so that the strategic stability that had underpinned the region's prosperity could be sustained into the future (Rudd September 15, 2011; Gillard March 10, 2011). The Australians were keen to remind the Americans that strong American leadership and capabilities were essential for the preservation of stability. Canberra repeatedly reassured Washington that the vast majority of the countries of Asia welcomed continued and expanded American strategic role in the hemisphere; and the consensus in ASEAN was that the United States remained irreplaceable in East Asia. Canberra also reassured Washington that Australia remained a loyal ally and a true friend of the United States, and that the U.S. alliance would continue to be regarded as vital to the nation's security and strategic interests, as demand for U.S. leadership and power would only be higher in the 21st century (Rudd September 15, 2011; Gillard March 10, 2011).

These arguments set the tone for the Labour government's U.S. policy and regional strategy. Beginning in 2009, if not earlier (arguably from the second half of 2008), Australia repeatedly warned the United States about the danger of being too soft on China or even capitulating to China's growing power and revisionist behaviour (Garnaut December 6, 2010). On the question of how to deal with a rising and more assertive China, Canberra also cast aspersions on the purpose of China's growing hard power and military capabilities in particular, which were deemed destabilising and threatening, and therefore needed to be contained. In a sense, the Labour government's regional diplomacy was executed largely through the alliance relations with the United States. By influencing Washington's strategic outlook and regional posture through the alliance linkage, Australia acquired extended strategic influence and more diplomatic leverage to shape the regional processes. Summits and regular consultations between Australian and American leaders through the AUSMIN (Australia-United States Ministerial Consultations) mechanism enabled policymakers of both countries to meet and discuss strategic matters on a fairly frequent basis. This helped foster trust and rapport between the two allies, not least on a more personal level between key individuals and policymakers such as Kevin Rudd and Hilary Clinton, who established a close working relationship in spearheading diplomatic offensives against China (Kelly December 8, 2012). Rudd reportedly always presented himself as a leader able to add value to U.S. dealings with China. It was also reported that Rudd's policy recommendations on how to deal with China were heeded and carried weight in Washington. Secretary Clinton had on many occasions publicly praised Rudd for his advice on China and even credited him for the U.S. decision to join the East Asia Summit (EAS). As China's assertiveness and expansionist tendencies became more apparent, particularly after 2010, the United States effectively pushed back against Chinese power in ways that strongly resembled what Kevin Rudd had privately advocated (Garnaut December 6, 2010)

### 2.5.1 Beefing up Allied Diplomatic and Defence Collaboration

As both countries' leaders recognised that a more focused and robust alliance partnership was the key to responding and adapting to the shifting power matrix in Asia, the Obama administration and the Labour government managed to chart a new course for the alliance and pledged to move the alliance forward with a 21st-century agenda (AUSMIN September 15, 2011a, 2011b; Sheridan November 6, 2010). Allied collaboration between the two administrations was mainly guided by one fundamental imperative: to adapt the alliance for the strategic challenges of China's rise in power. While counterterrorism, non-proliferation and the military efforts in Afghanistan and Pakistan still remained important agenda, their relevance had gradually declined and been marginalised by the growing regional strategic challenges in the wider Asia-Pacific region, with China being at the centre of that challenge. Under the alliance framework, the Labour government and the Obama administration deepened bilateral defence cooperation and renewed diplomatic collaboration in regional affairs. From the Australian perspective, these urgent efforts could help shore up U.S. strategic primacy and diplomatic influence and thus served Australian security interests well when U.S. strategic supremacy was increasingly tested. Moreover, having a strong alliance with the United States and formidable strategic capabilities were instrumental in maintaining Australia's geopolitical weight and strategic credibility as a capable middle power in a time of great change and uncertainty.

The Rudd government was also a staunch advocator of U.S. leadership in creating an open and inclusive pan-regional institutional architecture with a broad mandate (Rudd May 29, 2009; Rudd May 3, 2011; Rudd September 15, 2011). Part of Rudd's concern about the processes of regional institutionalisation was that over the decade following the Asian financial crisis they had excluded the United States. From the Labour government's point of view, only if the United States was brought in to curb China's growing centrality and diplomatic influence in East Asian multilateral institutions and remained in control of the regional process, could Australia's interest be protected and Canberra avoid being marginalised and ostracised; the United States had to underwrite the regional (institutionalisation) process, with its military capability, diplomatic muscle and sense of fairness. Hence, the Labour government was keen to advocate U.S. leadership in pan-regional institutions and urged the United States to formally join the EAS even after the Labour government had later quietly dropped the idea of an 'Asia-Pacific community'.

According to the WikiLeaks revelation, the Labour government's promotion of an 'Asia Pacific community' was intended to blunt Chinese influence and deny China regional hegemony in Asia (Kelly December 8, 2012). To Kevin Rudd's eyes, the overarching challenge for the Asia-Pacific region for the decade ahead was to ensure that all major regional institutions included rather than excluded the United States. Canberra asserted that this was a task Australia and the United States together as an alliance could see through. In retrospect, Kevin Rudd's goal for the proposed 'Asia-Pacific community' has been gradually achieved through the inclusion of the United States in the East Asia Summit. A pan-regional institution was beginning to emerge across the wider Asia-Pacific region in the form of the EAS. Canberra saw the EAS as a great opportunity for Australia and America to act as allies in regional security diplomacy. The Labour government repeatedly urged the Obama administration to strengthen the EAS' institutional structures, establish concrete security agendas and build links between it and other critical ASEAN-centred ministerial-level regional institutional arrangements such as the ASEAN Regional Forum, and the ASEAN Defence Ministers' Meeting Plus (Rudd May 3, 2011; Rudd September 15, 2011).

The allied defence relations were adapted for the post-2008 strategic circumstances centred on China's rise. At the turn of the decade, China's rise had nevertheless begun to feed into the agenda of the allied defence cooperation and transform the defence partnership. The strategic focus of the defence partnership between Australia and the United States shifted from the global theatre (the Middle East) back to the regional theatre (the Asia-Pacific/Western Pacific). This process was accompanied by a dramatic shift in strategic planning, capability requirements and force structuring from building a combined capacity for non-conventional combat against non-state actors to preparing for high-intensity conventional inter-state war between major powers in the Western Pacific. As far as non-traditional security agenda was concerned, the collaboration on counterterrorism and non-proliferation, which dominated the allied defence agenda during the Howard-Bush years, had been institutionalised as a matter of routine, whilst space and cyber security gradually emerged as the new practical and pressing agenda for the operation of the military alliance.

Canberra also agreed on the pre-positioning of U.S. defence materiel and military equipment in Australia and allowed increased U.S. access to Australian training, exercise and test ranges, as well as increased use by the U.S. military of Australian defence facilities and ports. These collective deliberations, which were carried out in the AUSMIN meeting in September 2011 and formally announced during President Obama's visit to Australia in November, were intended to 'send a clear signal to the Asia-Pacific region... and to those that would threaten us (Australia and America) that we are going to stick together… and that the United States will always maintain a very strong presence in that part of the world…' This constituted the single biggest change to the day-to-day working arrangements of the alliance since the negotiation of the joint facilities in the 1980s (AUSMIN September 15, 2011b). The arrangements of new force would lock the United States ever more deeply into a forward military presence in the Western Pacific (Miles May 21, 2012).

The Australian government also began the process realigning its own major force posture in tandem with America's regional military redeployment. Australia's Defence Force Posture Review (DFPR), which ran in conjunction with the U.S. Global Force Posture Review, was primarily about hedging against the threat posed by China's growing naval and air power to Australia's sparsely populated but resource-rich northern and western regions. The force posture review, which would be the most thorough full-scale appraisal of Australia's domestic military deployments in the past three decades, was intended to build on and refine the conclusions of the Labour government's 2009 defence white paper and help determine where Australia should base many of its planned new military capabilities for optimum regional use. The DFPR was basically designed to complement the ongoing work on U.S. force posture review and enhance Australia's capacity to assist U.S. military actions in the wider Asia-Pacific region. It bore out Australia's willingness to contribute to a U.S.-led military coalition in a future regional contingency against China.

## 2.5.2 Defence Build-up and New Defence Doctrines

The Labour government's 2009 defence white paper recommended the largest peacetime defence expenditure and called for the most dramatic military build-up since the Second World War (Defence May 2, 2009). A 'major new direction' of the defence planning was set out to build up Australia's maritime capabilities with the aim of having 'a more potent and heavier maritime force' by the mid-2030s in the Asia-Pacific. Notably, it was planned to double the size of Australia's submarine force by replacing the current fleet of six Collins class submarines with 12 conventional Future Submarine of a more capable class. This alone would be Australia's largest ever single defence acquisition project. The Australian government also pressed ahead with ambitious armament plans for the air force. For instance, a plan was laid out to enhance Australia's air combat capability by purchasing the fifth-generation multirole combat fighters, which would deliver a potent strike capability.

The long list of weaponry acquisitions marked a huge doctrinal shift in terms of the task priorities of the Australian Defence Force (ADF). The range of the planned weaponry and the costly expansion of sea and air defence reflected a return of the traditional emphasis on the 'ability to engage in conventional combat against other armed forces' as the most basic and main role of the ADF (Defence May 2, 2009). Priority was given to preparing the ADF for high-intensity interstate warfare and the risk of major power wars as well as deterring direct armed attack and ensuring the defence of maritime approaches to Australia. Other kinds of low-intensity non-traditional warfare were no longer treated as the most fundamental task and the most pressing force structural determinant. This represented a significant departure from the defence policy emphasis of the Howard Government in the post-9/11 era, which was realigned to reflect U.S. global security concerns, especially the needs of the coalition's war efforts in the

Middle East. Indeed, the white paper suggested that ‘the remote but plausible potential of confrontation with a major power adversary’ was ‘conceivable’, and envisaged that ‘Australia might have to attend to its local defence needs against a major power adversary in the event of its being involved in a wider conflict’ in the Asia-Pacific region. The defence document cautioned that such contingencies looked ‘unlikely’, but ‘are not so remote as to be beyond contemplation’ (Defence May 2, 2009). According to the white paper, Australia would face a real risk of being drawn into a regional security crisis and military contingency; and ‘… Australia might need to be prepared to engage in conventional combat in the region, in coalition with others, in order to counter coercion or aggression against our allies and partners’ (Defence May 2, 2009).

While reaffirming the critical importance of continued U.S. strategic preponderance, the defence white paper also put new emphasis on the importance of self-reliance as a defence doctrine. As weakened U.S. strategic predominance would cast doubt on America’s defence commitment to Australian security, in terms of U.S. willingness and ability to intervene militarily. Because China’s military rise would be accompanied by the weakening of U.S. strategic primacy over time, Australia had to begin to hedge its bets by enhancing its military capabilities and seeking to become more self-sufficient in national defence.

## 2.6 Conclusion

Although Chinese-Australian relations were primarily driven by the development of resource ties, the bilateral economic relationship was very much influenced by the nature of the evolving geopolitical realities of Chinese-Australian relations. In no small measure, China's increasingly vital resource partnership with Australia was grown out of a highly dynamic and complex geopolitical context. The analytical objective of this chapter was to set out this wider political context in order to analyse the bilateral resource politics in the subsequent chapters. The insights provided in this chapter suggest that the delicate strategic dimension of China's relations with Australia underwent two distinct phases during the 2000s.

The post-9/11 era featured a steady warming of the bilateral relations. Thanks to China's growing economic salience and strategic restraint in her foreign policy behaviour, China's rise was viewed benignly by the Howard government. As China sought stability in her relations with the United States, the post-9/11 stability of China-U.S. relations, which was anchored in a *modus vivendi* between Washington and Beijing, provided a generally permissive strategic environment for a Sino-Australian entente to occur. Given America's preoccupation with the War on Terror and the Middle East, Australia had much leeway to pursue a closer diplomatic relationship with China and to adopt a more accommodating posture on certain strategic issues without jeopardising alliance solidarity.

However, China's growing power and expansionist tendencies following the global financial crisis brought about a chain of systemic changes that led to a deteriorating regional strategic environment, characterised by intensified tensions in China-U.S. relations, changing U.S. regional strategic posture, and heightened strategic rivalry in East Asia. The deterioration in China-Australia strategic ties since 2008 was part of this wider geopolitical change. In response to the growing expansionist tendencies of China, Australia's Labour government reassessed the strategic implications of China's rise, reoriented its foreign policy away from China, built up defence capability and adapted the U.S. alliance to the challenge of China's rise.

From a theoretical perspective, the apparent realist dynamics in China-Australia relations suggest that the bilateral relationship does not reflect a typical situation of complex interdependence. Given the inherent strategic tensions between China and Australia, China's relations with Australia always contained a significant geo-strategic dimension under the sway of realist logic. Moreover, the revived realist security dynamics since 2008 indicate a further shift away from complex interdependence. According to complex interdependence theory, this general position of China-Australia relations on the spectrum and the recent tendency to move towards realism along the continuum, carry important implications for (the analysis of) the bilateral resource power politics.

The precarious nature of this realist strategic context underlines the geopolitical constraints faced by China in her bilateral resource politics vis-à-vis Australia. As the subsequent chapters will show, the geopolitical realities of Chinese-Australian relations entailed considerable strategic uncertainty and political constraints for the development of a genuinely reliable resource partnership. Chinese efforts to maximise resource interests therefore always faced inherent political risks in the bilateral relations. Despite Australia's important role in ensuring Chinese resource supply, the revived strategic tensions in Chinese-Australian bilateral relations during the post-2008 era began to undermine China's resource security interests. Given the lack of sustained political stability and genuine strategic trust between the two countries, the resource partnership was by no means an easy affair. For China, the scope for a genuinely reliable and fair resource partnership with Australia was limited at best.

Having emphasised the realist-focused strategic aspect of the bilateral relations, it is important to keep the discussion in perspective. Despite the realist dimension, complex interdependence remains the dominant character of China's relations with Australia. As Chapter 1 has already illustrates, the forces of economic globalisation largely prevailed in the context of China-Australia bilateral relations; and the extensive economic interdependence between China and Australia by and large reflect the key characteristics of complex interdependence. In terms of theory, it means that the overall position of Chinese-Australian relations is closer to complex interdependence than realism on the spectrum, even though it has been gradually shifting towards the realist end. What this suggests is that complex interdependence theory remains the more relevant analytical framework for the study of China's resource politics with Australia. The analysis of the bilateral resource power politics pertaining to the struggles over

Chinese resource investment and iron ore pricing in the following chapters, will mainly draw on the theoretical insights of asymmetrical interdependence under the condition of complex interdependence.

# Chapter 3 Struggle over Chinese Sovereign Resource Investment

## 3.1 Introduction

The previous chapter set out the geopolitical context of the resource power politics between China and Australia. From this chapter onwards, the study will seek to address the specific issues of China's resource politics with Australia. Whilst the next two empirical chapters focus on resource trade issues concerning iron ore pricing specifically, Chapter 3 is concerned with the investment aspect of the bilateral resource politics. More specifically, it discusses the power politics revolving around Chinese investment in Australia's resources sector. Indeed, one of the most difficult aspects of the bilateral resource relationship lies in the investment arena. China's investment ties with Australia have grown rapidly since 2008 thanks to the surge in Chinese government-related investment in Australia's resources sector. China's government-related foreign direct investment caused a huge controversy in the bilateral relations. Guided by a state-led mercantilist mission to acquire resources, Chinese government investors flocked to Australia in search of greater control of resource assets. In response to China's ambitious agenda, Australia sought to control and restrict Chinese government investment in order to protect her national interests. The controversy over Chinese government investment in Australia highlights one of the most important and thorny aspects of the evolving resource ties between China and Australia. This is therefore an arena in which the power dynamics behind the politics of the resource relationship plays out most intensely.

This chapter aims to answer the research question by addressing the power dynamics in the realm of resource investment. More specifically, its purpose is to examine Chinese efforts to shape and adapt to the power politics of China's dynamic resource investment relations with Australia, which will throw light on the limits of the bilateral resource investment ties and the nature of the resource partnership.

This chapter is organised in a structure designed to address some of the research objectives as outlined in Chapter 1, and focuses respectively on the roles of the Chinese actors, China's power position vis-à-vis Australia, as well as Chinese and Australian attempts to shape the power dynamics in the struggle for resource power. The analysis begins with a brief overview of the development of Chinese investment in Australia's resources sector. The next section analyses some of the general patterns of China's aggressive investment behaviour and explains the driving forces behind China's scramble for Australian resources. In particular, it considers the Chinese State-owned enterprise (SOE) investors' dual role as both mercantilist policy instrument for implementing the state's resource acquisition strategy abroad, and autonomous market entity pursuing an independent investment agenda. By exploring the nuances and complexities underpinning the relationship between the SOEs and the Chinese state, this section sheds light on the geo-economic and market rationales for China's growing investment interest in Australian resource assets, as well as the complicated roles and intentions of government investors in the Chinese investment spree in Australia.

The following two sections examine Australia's political and policy reaction to China's governmental investment in the resources sector. Section four offers a broad survey of the political reactions that were sparked against the influx of Chinese government investment from the various sections of the Australian polity, as well as the mining industry; while section five traces the successive major policy adjustments in Australia's foreign investment regime against foreign (Chinese) government-related investment from 2008 to 2010. It also seeks to highlight a number of typical case scenarios to demonstrate how the Australian authorities attempted to block and restrict Chinese (government) investment in the resources sector in order to protect Australia's national interest. The sixth section discusses Chinese misgivings about Australian discrimination against Chinese investment. In particular, it highlights deep-seated Chinese scepticism about Australian concern over the governmental background of Chinese SOE investors, as well the various Chinese interpretations of the Australian motivations for constraining Chinese government investment in the resources sector. The final section of the chapter discusses how the Chinese government and investors sought to adapt and adjust themselves to the investment predicament faced in Australia. By looking at how the restrictive Australian foreign investment regime was able to constrain Chinese government investment and alter Chinese investment behaviour, the analysis illustrates the vulnerable position of Chinese investors vis-à-vis the Australian authorities, and highlights China's true power position vis-à-vis Australia in the politics of resource investment.

The findings of this chapter reinforce the conclusion of the thesis, which argues that China has to cope with her vulnerability in her resource politics vis-à-vis Australia despite her growing power. China carried out a mercantilist strategy of resource acquisition in Australia via her government investment vehicles in an attempt to enhance her control of Australian resource assets. The Australian authorities were determined to protect Australia's resource domination by blocking and restricting China's government investment in the country's resources sector. This chapter argues that China's resource investors were vulnerable to Australian restrictions on foreign government investment. Despite their great financial power and mercantilist ambitions, the Chinese investors had no choice but to adapt to Australia's rather stringent and restrictive foreign government investment regime.

Having demonstrated Chinese vulnerability in the face of the Australian policy restrictions on Chinese government investment, this chapter also illustrates the limits of the resource investment ties. To a certain extent, the fact that the power politics have revolved around the Chinese resource investment issue is suggestive of the limited scope of the resource investment ties. Given the inherent sensitivity of the foreign investment issue, the political controversy that has arisen is indicative of the nature of the overall economic partnership and how far (or deep) the economic partnership can develop. Surely Australia's political reaction and policy response against the influx of Chinese resource investment can be most revealing in this regard. The intense power struggle and complex political manoeuvres on both sides have clearly revealed the lack of trust and depth in the resource cooperation that has seriously impinged on the development of a genuinely reliable resource partnership between China and Australia.

Chinese vulnerability in the resource investment politics can be best understood in terms of complex interdependence theory. As the previous chapter concluded, complex interdependence is a more prevalent condition than realism in China-Australia relations. According to complex interdependence theory, traditional (military) security agenda no longer dominate states' agendas, and the use of military force is too costly. Military power is no longer a viable policy instrument under complex interdependence; consequently, strong states will find it more difficult to use their overall (military) dominance to control outcomes on issues in which they are weak. Since the more powerful states can no longer use their overall dominance to prevail on their weak issues under complex interdependence, the linkage strategy/process whereby a state can use its overall power advantage to link policy issues in order to secure a favourable outcome of power struggle in a particular issue, breaks down (Keohane & Nye, 2011: 25-26). What this issue-specific perspective means is that the discussion of power politics under complex interdependence has to focus on the structure of power relationships specific to the issue under analysis: the outcome of power politics in a specific issue area has to be determined by the distribution of power in that particular situation, rather than by the overall power relationship between the two countries (Keohane & Nye, 2011: 42-44). By implication, the issue-structure model is a more relevant analytical perspective than the overall structure model in explaining the power dynamics in China's resource politics vis-à-vis Australia under complex interdependence.

The next relevant question is, what determines the structure of issue-specific power relationships? Complex interdependence theory postulates that the issue-specific power politics under complex interdependence can be explained by the liberal theory of power politics of (asymmetrical) interdependence. According to Keohane and Nye, states tend to manipulate asymmetrical vulnerability interdependence as a power resource to wield influence (Keohane & Nye, 2011: 14-15). Moreover, if a state is disadvantaged at the level of sensitivity interdependence but has the potential advantage over its rival at the level of vulnerability interdependence, it would raise the level at which the controversy is conducted by seeking favourable asymmetry in vulnerability interdependence (Keohane & Nye, 2011: 14-15). After all, according to the hierarchy of power resources model as developed by Keohane and Nye, power derived from asymmetrical vulnerability interdependence would ultimately dominate over power derived from asymmetrical sensitivity interdependence, since 'influence deriving from favourable asymmetries in sensitivity is very limited when the underlying asymmetries in vulnerability are unfavourable' (Keohane & Nye, 2011: 13-16). In other words, the key to understanding the power struggle behind the resource investment issue is the issue-specific power structure analysis that focuses on the patterns of sensitivity and vulnerability interdependence between China and Australia over the investment issue.

This theoretical exposition of the power dynamics of asymmetrical interdependence is extremely relevant to the analysis of the politics of foreign investment in this chapter. In fact, in order to illustrate the power dynamics, Keohane and Nye have used a typical example in relation to the power politics of foreign investment:

> *For instance, in a concession agreement, a multinational oil company may seem to have a*

> *better bargaining position of output, and the price, of the petroleum produced, thus making government revenues to company decisions. Yet such a situation is inherently unstable, since the government may be stronger on the vulnerability dimension. Once the country has determined that it can afford to alter the agreement unilaterally, it may have the upper hand. Any attempt by the company to take advantage of its superior position on the sensitivity dimension, without recognising its weakness at the vulnerability level (much less at the level of military force), is then likely to end in disaster.* (Keohane & Nye, 2011: 14-15)

Financially weakened by the global financial and economic crises, many of the Australian resource companies could easily have fallen prey to Chinese capital sponsored by the Chinese state. China's aggressive investment, which was largely driven by the state's desire to acquire and seize valuable resource assets, posed a serious threat to the Australian control of some of the country's most prized resource assets. In other words, China's scramble for Australian resource assets, if unchecked, would seriously undermine the established Australian dominance in the resource arena; consequently, the Australians were extremely sensitive to the impact of the influx of Chinese state capital, as they were the disadvantaged party vis-à-vis the Chinese government investors at the level of sensitivity interdependence.

However, the initial power advantage enjoyed by the Chinese government investors was indeed inherently unstable because the Australian authorities were stronger on the vulnerability dimension. As the host government, the Australian authorities had the ultimate upper hand because it could introduce policy measures to contain and restrict Chinese government capital. By raising the level of the political game to vulnerability asymmetry, the Australian government's intervention was able to protect Australia's control of the country's most vital resource assets from the unfavourable pattern of sensitivity asymmetry. The Chinese investors were vulnerable to the Australian government intervention and policy shift that discriminated against the government background and the strategic pattern of Chinese resource investment. Moreover, there were few private Chinese companies that were able to carry out substantial foreign direct investment in the capital-intensive resource acquisition projects abroad without state support. In the face of the exercise of Australian sovereign powers, the Chinese had no option but to conform and adapt their investment behaviour to the increasingly stringent Australian foreign investment regime targeted against foreign government investment. In short, although China's government investors had initially prevailed at the level of asymmetrical sensitivity, they ultimately succumbed to Australian dominance at the level of asymmetrical vulnerability. This power-oriented analysis of the politics of (asymmetrical) interdependence suggests that the Australians had the upper hand in the political controversy over the Chinese resource investment in Australia; despite China's overall power advantage vis-à-vis Australia (in both military and economic terms), the Chinese government investors remained the more vulnerable party in this particular issue area.

The discussion of the relationship between theory and the empirical analysis also pertains to the implications of the existence of realist dynamics in the broader political context of the resource investment ties. Although complex interdependence remains the more prevalent condition than realism in China-Australia relations, the previous chapter underscored the precarious and deteriorating bilateral strategic relationship, which nonetheless contained growing realist dynamics. As such, the realist dynamics must have had an impact on the resource power politics. According to Keohane and Nye, the position of a given situation on the complex interdependence-realism spectrum has real significance; after all, 'the position of a given situation along this continuum constitutes the independent variable' for analysis (Keohane & Nye, 2011: 270). In the context of this chapter, it can be asserted that the inherent strategic tensions in the bilateral political ties, and the growing adversarial dynamics in the strategic dimension of China's relations with Australia, were in no small measure responsible for the political tensions in the controversy over Chinese resource investment in Australia. Since these investment ties were grown out of such a complex political framework, the constraining influence of the latter on Chinese governmental investment also constitutes a primary theme of this chapter, as will be illustrated in the empirical analysis that follows.

## 3.2 The Rise of Chinese Resource Investment in Australia

Chinese investment in overseas resource sectors constituted a significant share of China's total direct overseas investment. Australia was one of China's largest overseas investment destinations as well as the largest host of China's outbound resource-related investment. The Portland aluminium smelter and the Channar iron ore joint venture established in Australia in the 1980s used to be China's largest overseas investment projects (Drysdale & Findlay, 2009).

Chinese investment in Australia's resources sector was a fairly recent phenomenon, and began to increase only during the first decade of the new century.[47] Having recognised the importance of acquiring overseas market and resources through outbound foreign direct investment, the Chinese government began to encourage more Chinese outbound investment starting in the late 1990s. Driven by the so-called 'going abroad' policy initiative, Chinese investment in the Australian resources sector increased. The steady improvement in bilateral political ties from the late 1900s onwards had to some extent given the China-Australia trade and investment relationship a significant boost.

The relations continued to warm and experienced a rare period of amity and stability during the turn of the new century. China's economic take-off and the stabilisation of major power relations in the post-9/11 era created a benign economic and strategic environment for the steady improvement in the bilateral ties. The new Chinese leadership harboured great expectations for China's relationship with Australia in both political and economic terms; and Australia had increasingly come to be seen as a valuable resource partner to support China's economic development. Nevertheless, despite a few sporadic resource investment endeavours in the early 2000s, China's resource-related investment in Australia did not really pick up speed until 2005.

The emergence of the Sino-Australian entente around the mid-2000s heralded the beginning of a new phase of China-Australia economic partnership. Chinese investment in Australia also started to gain momentum in the second half of the 2000s as China began to target Australia as a key resource base and supplier. Official visits by the Chinese Premier and the Chinese President in 2006 and 2007 not only

[47] Interview 4

helped secure huge energy and minerals procurement contracts but also large resource investment projects.[48]

The global financial crisis in 2008 gave fresh impetus to Chinese investment in Australia. The economic downturn of 2008/2009 caused a plunge in the value of Australian mining assets and created an unprecedented investment and acquisition opportunity in the country's resources sector for resource-hungry Chinese capital. As Chinese investors scrambled for Australia's mining assets during that turbulent period, the influx of direct Chinese investment picked up speed and reached a climax towards the end of the 2000s. By the end of 2011, the cumulative total direct Chinese foreign investment in Australia reached US$29.7 billion[49] (MOC April 11, 2011). What was more impressive was the speed and scale of the surge in Chinese investment, which became the most remarkable phenomenon in the development of China-Australia economic relations in recent years.

The bulk of the Chinese investment in Australia went to the mineral and energy resource sectors. Insofar as the investment in mineral resources was concerned, the Chinese investors were most interested in iron ore assets, which made up the biggest share of the total Chinese resource investment in Australia. Resource assets such as bauxite, copper, nickel, zinc and other non-ferrous metals were also amongst the popular investment and acquisition targets for Chinese companies. Natural gas and coal made up the bulk of Australia's energy exports to China as well as the most important and attractive energy assets for the Chinese investors.

Direct Chinese investment in the Australian resources sector has taken a variety of forms. Many projects were 'greenfield' investments, whereby Chinese investors invested directly in resource development projects. Such direct investment projects usually took the form of joint ventures with other transnational firms (usually the local Australian partners) in the mining sector. These projects would require the Chinese investors to be directly engaged in the mineral exploration, mine development, mineral extraction, and sale. This type of 'greenfield' investment dated back to the 1980s and characterised most of the early Chinese investment in Australia's resources sector before the 2008 financial crisis.

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[48] Interview 44

[49] In 2010, China's investment in Australia increased by US$2.93 billion year on year (China News January 18, 2011).

The more recent investment endeavours in the post-2008 era were marked by a surge in Chinese portfolio investment, whereby Chinese firms sought to acquire stakes in Australian resource businesses. This investment approach was pioneered by China's largest private steel mill – Shasteel, and was quickly followed by China's state-owned companies. This form of investment might not necessarily lead to direct Chinese involvement in the operation of the target company, but the Chinese investors were entitled to the usual benefits of a stakeholder in accordance with the size of the Chinese shares in the target company and the specific arrangement that had been worked out and agreed to by both sides before the acquisition. The ambitions of the Chinese investors varied from case to case, and ranged from gaining a controlling stake in the target company to becoming a strategic partner with a rather limited role in the target company's management. There were also cases where the Chinese investors resorted to capital market operations to launch hostile takeover bids. Such cases were rare but there had been successful examples in practice.

In conceptual terms, portfolio investment is strictly speaking not direct investment according to conventional understanding. However, these days the line between direct and portfolio investment is blurring. In statistical terms, investments are counted as direct investment by the Australian government if the proportion of the acquired stake exceeds 10 percent of the total company stock, and has real impact on the operation of the target company; for instance, on the sales strategy[50] (Drysdale & Findlay 2009). For analytical purposes, this form of Chinese portfolio investment will be treated as direct investment in this analysis. Transnational portfolio investment through mergers and acquisitions has increasingly become the predominant form of China's outbound resource investment in Australia.

The controversy over Chinese resource investment in Australia has centred on the government background of the Chinese investors. The majority of the Chinese investment entities have been state-owned enterprises or state-controlled public companies, which were China's national champions from a variety of resource-related industries and sectors, most notably the iron and steel industry, the

[50] Foreign Investment Review Board (FIRB): 'Glossary'. *Foreign Investment Review Board, the Australian Government*. Retrieved from http://www.firb.gov.au/content/Publications/AnnualReports/2009-2010/Glossary.asp; see also: 'Definitions' at http://www.firb.gov.au/content/definitions.asp?NavID=10

non-ferrous metallurgical industry and the mining industry. There were also national SOEs from the resource development-related construction and heavy machinery manufacturing industries, and even the transportation sector. These companies were actively involved in the development of large mining facilities for many of the giant Chinese resource projects, mostly in the vast mining region of Western Australia, where the basic mining and transportation infrastructures were under-developed and had become increasingly inadequate to support the rapidly expanding mining activities.

## 3.3 Accounting for the Surge in Chinese Resource Investment

The surge in Chinese resource investment in Australia since 2008 occurred as a result of a combination of several domestic and international factors. Growing Chinese demand for minerals and energy resources was the most significant factor behind the rise of Chinese investment in the overseas resources sector since the second half of the 2000s. The growing wealth of the Chinese government and investors was another major factor contributing to the rapid increase in Chinese outbound foreign direct investment to acquire resource assets globally. The Chinese government had not only amassed huge foreign exchange reserves of around 2 trillion U.S. dollars, but also faced the problem of how to invest this growing fortune and diversify its investment portfolio and reduce investment risks (Bardeesy July 4, 2009). In this regard, mineral and energy resource investments had come to be seen as a good alternative investment option. Given the growing Chinese anxiety over resource security and the expectations of rising commodity prices over the long run, the idea of holding resource assets abroad had gained increasing currency in China's policy and business circles.

In the above context, Australia's abundant resource reserves, the high-grade quality of its minerals (such as iron ore) and the country's good investment environment in general were the main attractions for Chinese investment in Australia in recent years. The rapid growth of the Chinese economy since the early 2000s led to a breathtaking growth of investment in China's steel and non-ferrous metallurgical industries.[51] The first wave of expansion of the resource-intensive heavy industries occurred between 2003 and 2007. It was followed by another round of expansion after the 2008-09 global financial crisis, as the post-crisis domestic economic stimulus package encouraged further expansion of those resource-intensive manufacturing industries.

The rapidly surging prices for imported minerals (most notably the soaring prices of imported iron ores since 2003) had significantly raised the production costs and squeezed the profit margins of the metallurgical industries in China. There had been a growing strategic imperative to increase control over upstream raw materials (especially with respect to pricing) to ensure reliable and sustainable access to mineral supplies from abroad. In this sense, the 'greedy' global mining companies helped fuel Chinese

[51] Interview: 47

enthusiasm for investing in the Australian resources sector.

Furthermore, the global financial crisis had a devastating systemic impact on the global economy and created a very rare historic opportunity for Chinese investors to buy up overseas resource assets. The declining global demand for mineral and energy resources during and immediately after the financial crisis led to the sharp plunges in the global commodities markets and the prices of resource assets. The asset values of many Australian resource companies had fallen to a historic low; this considerable drop in asset value rendered these Australian companies more attractive for investment and acquisition. At the same time, the financial and economic turmoil had put a severe strain on the finances of the resources companies from the mining and energy sectors globally. Many Australian resource companies, big and small, encountered cash flow problems; some were threatened by debt crisis partly due to over-expansion during the boom years. The urgent financing needs of the Australian resource sector during and in the aftermath of the financial crisis had significantly lessened resistance and obstacles to Chinese investment, and rendered Chinese capital all the more welcome. From the Chinese perspective, the financial crisis presented a ‘once in a hundred years’ historical opportunity for bargain hunting in the global resources sectors (Anonymous author November 28, 2008; Zhang, 2010: 37-38, 86-88; Jia December 20, 2008; Liu December 22, 2008). Chinese resource investment interests in Australia’s mining and energy sectors therefore reached an all-time high in the aftermath of the financial crisis. This round of investment and acquisition was further fuelled by a declining Australian dollar during the crisis period (Anonymous author, 2008).

The improvement in China’s policy environment also helped facilitate outbound resource investment. In the past, overseas investment had been strictly regulated and restricted by a tight Chinese regulatory regime. Since 1997, the Chinese government had begun to encourage Chinese companies to invest abroad. During the 2000s, the Chinese government attempted to facilitate and support more Chinese outbound investment with less regulatory restrictions and greater financial support. This ‘going out’ strategy corresponded to and was reinforced by China’s overseas resource acquisition strategy, which also encouraged and supported Chinese investment in overseas resources sectors.[52] Indeed, a

[52] Interview: 38

significant proportion of the so-called ‘going out’ efforts were targeted at the resources sector. Much of the government’s policy deliberation to remove the regulatory hurdles was designed to create a policy environment more conducive to resource acquisitions abroad (Zhang, 2010: 159-166; Jia December 20, 2008). The Chinese government loosened the regulatory regime by making government verification and approval more efficient and easier for companies seeking to invest in overseas resources projects. There were also increases in fiscal, foreign exchange and banking assistance from the state to help finance big resource-related overseas investment endeavours during the 2000s (Liu December 22, 2008).

The 2008 financial crisis had speeded up this development by giving a new impetus to the government’s push for the country’s overseas investment programme. The Chinese government acted quickly to introduce and implement a series of policy changes that aimed to facilitate outbound investment and encourage resource-related companies to take advantage of the investment opportunities presented by the financial crisis (Zhang, 2010). Overseas resources investment was the preferred target for state support; and in this regard, Australia was one of the most important investment destinations for state support.

China’s banking regulator in 2008 loosened the regulation by providing Chinese investment entities with easier access to banking services and allowing qualified domestic commercial banks to arrange and provide loans for overseas acquisition, which had become an important means of financing for transnational acquisition activities undertaken by Chinese firms (Liu December 22, 2008). The state’s foreign exchange authorities also endeavoured to offer greater access to the nation’s foreign exchange reserves to support overseas investment. Major Chinese policy banks such as the China Development Bank and the Export-Import Bank of China also provided easy credits to Chinese investors seeking to engage in overseas resource-related projects.[53] Some of China’s multi-billion investment and acquisition deals, regardless of their outcomes, were made feasible only with the generous financial support from state-owned commercial and policy banks. These state-owned lending institutions had become an indispensible source of finance for many of China’s largest overseas resource investment and acquisition deals, such as Chinalco’s 2009 acquisition deal with Rio Tinto, which was worth 19.5 billion U.S. dollars

[53] Interview: 8

and eventually failed (Zhu June 5, 2009); and Valin Steel's acquisition of 16.5 percent stake in Australia's third largest iron ore producer, Fortescue Metals Group, which was worth US$770 million and was completed successfully (Bardeesy July 4, 2009). The Ministry of Commerce and the National Development and Reform Commission (NDRC) also looked with favour upon overseas resource investment applications and proposals. In 2009, the Ministry of Commerce introduced a new regulatory regime that aimed to simplify and better streamline the state's verification and approval procedures for overseas investment applications. For instance, by giving local governments greater authority to oversee overseas investment proposals while minimising the control of the national (central) government over the process; the regulation also gave greater autonomy to Chinese companies in determining the viability and feasibility of their overseas investment projects (China News March 17, 2009). Resource-related investment projects were always favoured by these policy measures and reform initiatives.

### 3.3.1 China's Aggressive Investment Behaviour and Mercantilist Intentions

Chinese SOEs' ambitious investment and acquisition approach was a serious cause for alarm and fuelled Australian mistrust of the intentions of Chinese investment. The perception of an imminent threat of Chinese state domination in Australia's resources sector was reinforced by aggressive and calculated Chinese investment behaviours such as: aiming at the most valuable resources and core assets; striving for controlling stakes and substantial interests in target companies; seeking board seats, information access and corporate decision-making powers in target companies; paying scant attention to financial risks; and not paying significant heed to the commercial viability.[54] In light of the determined and ambitious Chinese takeover bids launched by the giant SOE investors such as Sinosteel and Minmetals (for Midwest and OZ Minerals respectively), most Australians believed that Chinalco would progressively increase its shareholding in Rio and eventually seek a complete takeover of Rio Tinto in due course, despite Chinalco's repeated protests that it had no intention of doing so (Callick June 6, 2009; Hou, 2010).

Even the Chinese themselves had recognised the threatening nature of such an aggressive approach, as

[54] Interview: 44

well as its limitations. Some Chinese observers recognised that Australian perceptions could not merely be dismissed as innocence and bias, and called for a more restrained approach to resource acquisition.[55] In their joint post-mortem on the collapse of the Chinalco-Rio deal, Chen Daofu and Su Yang warned against an overly ambitious approach in the acquisition of overseas resource assets. In light of the fact that China's resource investors consisted largely of government companies engaged in an aggressive state-initiated resource acquisition strategy, China's resource investments were bound to face some degree of wariness and resistance on the part of the host governments and local communities. However, they suggested that as latecomers and new players in the global resource arena, Chinese resource investors should avoid aggressive acquisition of substantial/controlling stakes in foreign resource companies; nor should every Chinese investor aim for a board seat in the target company. In their view, both of these aggressive investment behaviours, that had played a role in Chinalco's failure, were neither viable nor necessary (Chen & Su, 2010a, 2010b). Hou Minyue also had serious reservations about the aggressiveness of Chinese investment behaviour in Australia's mining sector: the Australians were completely overwhelmed by the intensive Chinese investment activities carried out within such a short period of time; the enormous capital injection especially into the targeted mining giants with high-quality and well-developed resource assets, as well as a number of ambitious takeover raids on mining companies; and the Chinalco-Rio deal was the most notable example in this regard (Hou, 2010).

Despite Chinese reassurances, the Australians had become increasingly wary of the market implications of growing Chinese ownership. Mounting fears of Chinese control over Australian resources were not only about the extent of Chinese ambition to expand her growing presence in terms of enlarging Chinese ownership *per se*. Amongst Australia's greatest concerns was the progressive and creeping Chinese attempts to seek greater pricing power and the long-term impact on the prices of major commodities that Australia exported. Arguably, the prospect of Chinese acquiring a significant influence over the pricing of iron ore was the least desirable outcome for the Australians. Yet, insofar as China's resource acquisition strategy in the Australian theatre was concerned, the quest for pricing power was one of its driving motives, if not the most immediate objective.[56]

[55] Ibid.

[56] Interview: 8

Indeed, the growing Chinese desire for pricing influence was keenly reflected in the insatiable appetite of the Chinese sovereign investors for Australia's iron ore assets. Although access to ore supplies was also a major consideration, the quest for greater pricing power was the main impetus for the surge of Chinese investment in Australia's iron ore mines since 2008 (Liu December 22, 2008). China's strong desire for pricing power led to a systematic and aggressive asset acquisition spree, via a number of strategic investments in Western Australia and other iron ore producing states in Australia. This round of the aggressive iron ore acquisition strategy, which targeted the core assets of the established giant iron ore producers and the major undeveloped mining assets owned by the smaller Australian miners, was undertaken by a handful of China's most powerful SOE investors. It was hoped that acquisition of a significant proportion of stakes in Australia's major resource companies would over time help Chinese firms establish some degree of influence over the pricing policy of the upstream resource suppliers, thus reducing the cost of raw materials for the downstream iron and steel industry in China (Rong & Ye February 23, 2009).

This strategy was based on the presumption that increasing stakes in iron ore mines abroad would reduce Chinese dependence on the dominant miners for ore supply, as well as enhance Chinese steel mills' bargaining position and influence over the prices of imported iron ores - thereby rendering the downstream Chinese steel industry less vulnerable to iron ore price hikes (Rong & Ye February 23, 2009; Li, 2010). Even if increased stakes in upstream resource companies failed to strengthen Chinese pricing power, they would nevertheless help enhance Chinese ability to cope with hikes in iron ore prices and the resultant rising production costs, which would be expected to be offset by the gains from the increased dividends received as significant shareholders of the upstream raw material suppliers. This has been the experience of the Japanese steel mills, which benefited from their significant stakes in upstream iron ore producers acquired in the 1970s and 1980s. This partly explains why the Japanese steel industry, in relative terms, appeared significantly less sensitive than its Chinese counterpart to the dramatic rises in imported iron ore prices over recent years.[57]

Chinalco's investment bids for Rio Tinto stakes were the most notable example in this regard. The 2000s

[57] Interview: 9

witnessed a merger and acquisition spree in the global resources sector involving the largest cross-border deals in history. Even as the global credit crisis was beginning to unfold, the scramble for resources reached its zenith by late 2007, when Rio Tinto became an acquisition target of BHP Billiton. BHP was then the third largest producer of iron ore and second of copper globally, whilst Rio was the second and fifth respectively. The proposed merger would have created the largest single producer of iron ore and copper, as well as aluminium and power-station coal, in the world. The imminent tied-up between the two Australian-based global mining giants would lead to further consolidation of the global metal mining business. This would threaten to push up the costs of China's development considerably, given China's massive demand for metals such as iron, steel and copper, driven by the country's breakneck economic growth. It was against this global market background that Chinalco's two successive strategic moves to invest in Rio Tinto in 2007/2008 and 2009 were conceived and implemented.

Owing to the collapse in demand for aluminium, Chinalco's profits dropped by 99 percent in 2008, and its original 2008 investment in Rio Tinto lost 70 percent of its market value, approximately US$10 billion (Yao & Sutherland, 2009). Despite the loses, four of the biggest Chinese state-owned banks (including two state policy banks) lined up to lend Chinalco US$21 billion at very low interest rates for its second bid for Rio's stake (Yao & Sutherland, 2009). Moreover, Chinalco's acquisition moves appeared to defy commercial logic and existing theories concerning foreign direct investment and acquisition in the light of the fact that the company had no distinct advantages over Rio Tinto and was in fact smaller and less profitable than its target company. As a result, Chinalco's ambitious international expansion and desire for vertical integration with Rio could only be fully explained in terms of state-sponsored resource acquisition act and China's growing dependence on mineral resources[58] (Yao & Sutherland, 2009). From the Australian perspective, it was also legitimate to question why one should sell assets to Chinese firms that could sacrifice commercial efficiency in the service of state objectives.

In retrospect, Chinalco's successful first move into Rio Tinto in early 2008 was already an indication of the company's important status in the overseas resource acquisition strategy and the national mission

[58] Interview: 32

entrusted to it by the state to become China's globally diversified mining champion. Given the strategic significance of its failed second attempt in 2009 to acquire a large stake in Rio Tinto, Chinalco was surely in the vanguard of Chinese acquisition of iron ore assets in Australia. Indeed, the case for approval of the deal was reportedly being pressed at almost every encounter between Chinese officials and Australians, in both countries, whatever the reason for the meeting (Callick May 13, 2009). None of the other Chinese investment moves into Australia had anything like the same weight in the eyes of the Chinese government, which had pulled out all the stops to support Chinalco's bid for Rio Tinto. Where core national interests were concerned, the Chinese government was sufficiently well managed to ensure its state priorities would take precedence. Hence, although Chinalco was not itself a buyer of iron ore, it would be hard to conceive of Chinalco being free, in its amplified role in Rio Tinto, to maximise iron ore prices, given the fact that Rio Tinto was Australia's dominant iron ore producer and China was Rio's biggest iron ore customer.

The Australian government therefore remained rather cautious about approving major Chinese investment projects that would have a systemic impact on the iron ore trade in China's favour at the expense of the Australian companies and industry. Mindful of the strategic rationale behind China's iron ore acquisition strategy, the Australian authorities had been keeping a firm grip on the scale and pace of the inflows of Chinese capital lest the latter should be able to undermine Australian control over iron ore pricing.

China's domestic propaganda and media reports that trumpeted Chinese achievements in overseas iron ore acquisition also reinforced Australian mistrust towards Chinese investment intentions. Remarks by senior Chinese officials about how China's strategic investments in overseas resource assets could help the country control key commodities (such as iron ores) and their import prices received extensive press coverage. For example, Wang Xiaoqi, the planning director at the State-owned Assets Supervision and Administration Commission of the State Council that owns Chinalco, once told *21st Century Economic Report*, an influential Chinese business newspaper, that 'stabilising the prices of mineral resources should be the aim of this round of overseas acquisition for resources' (Callick May 13, 2009). Official comments and media commentaries on why overseas resource investment should be encouraged and promoted, and how the central government mobilised and coordinated major overseas resource investments, also appeared in the press. It was widely reported in Chinese media that the proposed Chinalco acquisition deal was directly handled and managed by the State Council and the State-owned Assets Supervision and Administration Commission (SASAC) (Xu February 12, 2009). These startling revelations about Chinese investment motives only further undermined China's own claims of its modest resource and investment ambitions, and confirmed Australian and foreign suspicions (Liu & Liu & Liu February 3, 2009). Hence, the Australian criticisms levelled at Chinese sovereign investment were not entirely xenophobic.

Australian mistrust of Chinese intentions was further undermined by the lack of adequate communication between the Chinese and Australian governments on major Chinese investment projects.[59] Canberra was concerned that Beijing had been less than willing to consult with the Australian government concerning major Chinese investment moves before they were formally launched. For instance, Chinalco's 2007/2008 raid on Rio shares had taken Canberra by surprise. Neither Rio Tinto nor Canberra reportedly knew anything about Chinalco's meticulously planned raid on Rio shares in London when Chinalco bought its initial 9 percent stake in the company in late 2007, with the transaction completed in early 2008[60] (Callick June 6, 2009). Chinese Foreign Minister Yang Jiechi commented on a visit to Canberra soon afterwards (in early 2008) that this was not a government-initiated strike and denied he had been aware of the development. However, the Australians were left unconvinced; and the lack of frank exchange about the deal fuelled Australian suspicion and compounded the challenge for Chinalco's second major bid for Rio stakes in the following year (Hou, 2010). It was an important event that led to the context in which the six guidelines on foreign government investors were deliberated in the following year.

### 3.3.2 Strategic Role of National SOEs in the State's Overseas Resource Acquisition Strategy

As to the identity of the Chinese government investors, an important dimension of the question pertains to the relationship between the national (or central) SOE investors and the Chinese state. As an integral

[59] Interview: 44

[60] Chinalco reportedly failed, until prompted, to seek Foreign Investment Review Board approval for its acquired stake, as required of all state-owned companies (Callick June 6, 2009).

part of the Chinese state apparatus, the national SOEs are owned and regulated by the State-Owned Assets Supervision and Administration Commission of the State Council (SASAC). It is reasonable to assume that the national SOE investors were effectively investment entities 'of the state', 'by the state' and 'for the state'. Their business interests constituted the economic interests of the state; state interests were also embodied in the interests and aspirations of the industries and economic sectors dominated by those national SOEs. Top managers of the national state companies were high-level party cadres appointed by the central government (i.e., the Party); many came from a bureaucratic background; and some successful managers would later be transferred to the government bureaucracy by the party-state as political reward. As guardians of state interests, these state appointees were, in general, keen to execute state policy and follow the will of the central government.[61] Success in this regard could lead to personal political benefits and career advancement in government for those top management personnel with political acuity. The most notable example in this regard was the promotion of Chinalco's General Manager Xiao Yaqing. Xiao, who was an alternate member of the Central Committee of the Communist Party, left Chinalco to become Deputy Secretary-General of the State Council shortly after the announcement of the Chinalco-Rio deal. His government role was to assist the Vice Premier responsible for the nation's industrial development. Xiao was hailed by the Chinese media as 'a national hero for promoting overseas acquisitions'[62] (Callick May 13, 2009). Xiao's predecessor in Chinalco had also become the Vice Governor, and later the party secretary, of Guangxi Province (Callick May 13, 2009). The significance of Xiao's timely promotion was widely cited in both the Chinese and Australian media, and testified to the close links between Chinese corporations and the state (Xiao & He & Bai, 2010; 141).

The close institutional relationship between the national SOEs and the Party state seems to justify the 'China Inc.' view when it came to how the major Chinese government investors were perceived abroad. The national SOEs were politically responsible for the central government and were charged with policy missions to fulfil state objectives, as well as to protect and advance national interests (Liu December 22, 2008). If required, they could be used as policy instruments by the government for national economic

[61] Interview: 8

[62] Source: 'Reasons for Chinalco's Failure' (June 10, 2009)
http://money.163.com/09/0610/15/5BF5BNBB00251LJJ.html

agenda.[63] As the commercial agent of the state or the central government, they were obliged to carry out, execute and implement national economic strategy. The central government led behind the scenes by determining the strategic goals, coordinating domestic actors, mobilising national resources and providing policy and financial support;[64] whereas the national SOEs were at the forefront of China's inter-state economic diplomacy and transnational economic engagement. For instance, the idea of acquiring Rio Tinto was first conceived after the NDRC summoned Chinalco, Baosteel, Shenhua Group and the CDB on a number of occasions at the end of 2007 to discuss a Chinese response to BHP Billiton' proposed acquisition of Rio Tinto. Chinalco was hand-picked for the task of forestalling BHP's acquisition plan, and was soon approved by the SASAC to expand the company's main business scope to cover mining and all the non-ferrous metals in order to clear the way for Chinalco's plans to acquire Rio Tinto. (Xiao & He & Bai, 2010: 129).

In the resources sector, the national SOEs were the principal executors of the nation's overseas resource acquisition strategy. Notably, the SASAC reportedly selected a group of task force-like national state companies specifically for carrying out those biggest overseas resource-related investment and acquisition projects, which were deemed strategic moves and of critical importance in China's overseas resource strategy; according to a senior SASAC official, this group consisted of ten national SOEs who came from the petroleum, metallurgical, mining and other resource-related industries; and all of them were industry leaders in those sectors (Jia December 20, 2008; Liu December 22, 2008). Through these critical foreign investment projects, China was seeking to establish and expand its foothold in the global

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[63] Interview: 8

[64] The uniqueness of the Chinalco-Rio Tinto deal was underlined by a compelling account in *Caijing* of the way it was being financed. The state-owned policy bank - China Development Bank (CDB) - was the leader of the consortium loan funding the Chinalco-Rio Tinto bid. Although it had been officially inaugurated in early 2009 as a commercial institution, the CDB remained essentially a major vehicle for providing 'policy loans' and politically-directed capital transfers to fund China's major resource ventures abroad. Even its two major government shareholders – the Ministry of Finance and the People's Bank of China's Central Huijin Corporatoin, which held China's foreign exchange reserves – were not notified by the bank about these huge special-purpose deals involving giant national SOEs such as Chinalco and China's big oil corporations. As part of the nation's energy strategy and foreign policy, these mega-sized deals were directly decided by the State Council without following the CDB's usual corporate governance principles. In this regard, the CDB had to execute the transactions regardless of their commercial risks and profitability (Callick May 13, 2009). Source: 'CDB Troubled By Chinalco-Rio Deal' (November 27, 2009) http://www.caijing.com.cn/2008-11-27/110032362.html

mining and extraction sectors, and to protect and promote the long-term developmental and commercial interests of its downstream metallurgical and energy businesses. The central government intended to mobilise all necessary resources from the state apparatus to support their overseas endeavours. The chosen national champions were proud to be at the vanguard of the nation's resource acquisition strategy (Chinalco August 24, 2011). The national SOE investors had been the indispensible agent of the overseas resource acquisition strategy. Many resource investment projects were not entirely driven by commercial investment objectives, but were also strategic national investments undertaken by the national SOEs on behalf of the state in support of its resource security strategy. It was the central government that had provided the political impetus for these mega projects, which were oriented to the national goals of sustainable economic development and the security of resource supply.

Large resource-related investment projects, be they greenfield investments or mergers and acquisitions, were capital-intensive, high-risk, and required long-term commitment, which meant that state support, if not direct government involvement, were essential for their viability and success. Despite their domestic success (achieved with the support from the state), these national champions were novices in the international resources arena.[65] Because of the risky nature of big resource-related investment undertakings and the volatility of the global commodities market, commitment to these national missions might lead to the compromise of short-term business interests. From the firm's perspective, many of the giant resource projects might not necessarily make much financial sense, as they entailed too many investment risks or debt burdens on the part of the investors from a business point of view. To undertake these risky mega projects, the firms would likely have to compromise their short-term interests.[66] Some of the investment initiatives might not necessarily have direct relevance to the corporate agenda or the long-term development needs of the firms that were tasked with carrying them out.[67]

Nonetheless, the national SOE investors were backed by the state, both materially and politically; the government ensured that they had a considerable margin for error and investment loss, so long as their overseas investment deals made strategic sense in the long run. In fact, by undertaking the initiative to

[65] Interview: 32

[66] Interview: 8

[67] Interview: 32

pioneer the state's resource strategy at the cost of their business interests, the national imperative of seeking expansion of the state's resource territory abroad might very well translate into the companies' own agendas, necessitating it to alter its corporate and business strategy accordingly. Most importantly, given the government's full backing for the sake of resource acquisition, these national SOE investors could quickly diversify their business portfolios, increase their company assets, expand their global presence, and elevate their corporate profiles internationally; all of which served their long-term interests for growth that would not have otherwise been possible.

*Autonomy of Chinese SOEs as Market Actors and Business Motivations for Overseas Resource Investment*

China's national SOEs by and large faithfully executed the state's resource strategy. Nonetheless, China's government-related investors acted simultaneously as market actors that enjoyed a considerable degree of autonomy over their own corporate affairs, including their investment decisions. It is therefore necessary to place their relationship with the government in perspective. After all, China no longer had a command economy. Despite their close links with the government, Chinese SOEs had over the years become increasingly oriented to the requirements of a market economy, following years of SOE corporate governance reforms. As much profit-oriented as private commercial entities, Chinese SOEs also had strong incentives to operate according to market forces. When it came to overseas investment decisions, the behaviour of the SOEs was not micro-managed by the government. Insofar as national SOEs were concerned, those powerful national enterprises possessed a considerable degree of autonomy.[68] The top management of some of the big national champions were high ranking party cadres of ministerial or vice-ministerial levels and enjoyed considerable leeway and autonomy in business management, including on the question of overseas investment. For China's numerous local SOEs, market forces might override the perceived state agenda; and commercial logic might be a better guide for understanding their overseas investment behaviour. Contrary to popular perception, the Chinese government was on the verge of losing its grip on Chinese SOEs' overseas investment activities. Government regulation and official supervision in this particular policy domain was said to be impotent and limited (Qi May 11, 2010; Finet April 27, 2010; Deng May 5, 2010). An institutionalised performance

[68] Interviews: 8, 32

management framework was not yet properly developed to oversee the country's vast (resource) investment ventures and assets abroad (Lu & Li July 4, 2011; Li, 2011). The pace of overseas expansion of the national state companies had outrun the regulatory capacity of the SASAC and other regulatory bodies, such as the Ministry of Commerce and the NDRC. The central government was in fact struggling to keep up with the overseas ventures of national and local government-related companies, whose scramble for resource investment opportunities abroad lacked a clearly formulated strategy to coordinate their activities.

Despite the state missions and national resource security strategy entrusted to national SOEs, the overseas resource investment activities of these enterprises were very much driven by market considerations and commercial logic. In many respects, the industry- and firm-levels business imperatives were consistent with both the national resource security interest and the development needs of the Chinese businesses in the relevant sectors;[69] it thus blurred the distinction between state-directed behaviour and market-oriented commercial decisions.

A significant driving force was the industry imperative of vertical integration, whereby the steel mills and non-ferrous metallurgical producers in China sought to upstream supply chain integration.[70] Insofar as the downstream resource-related Chinese metallurgical sectors were concerned, the goal was to gain greater and more reliable access to raw materials abroad and to improve the competitive edge of the downstream metallurgical industries and companies, by ensuring a minimum and optimal level of Chinese control of the costs and supply of essential raw materials. Chinese ownership of upstream mines would supposedly reduce supply risks and stabilise the procurement of minerals. By acquiring more overseas captive mines (*quanyi kuang*), downstream Chinese companies could ensure a more secure supply of raw materials from abroad, and presumably at a fair price. Apart from greenfield investment, acquisition of stakes in upstream mining companies and their mineral assets, would also give Chinese investors the chance to negotiate agreements with the targeted companies so as to guarantee the Chinese side adequate supplies of the mining output from the target companies.

[69] Interview: 38

[70] Interview: 32

However, Chinese metallurgical industries had only limited control of minerals assets outside the country. Take the Chinese steel industry in 2008 for example: the volume of iron ores imported from China's overseas captive mines amounted to only 700 to 800 million tons a year, which accounted for only 20 percent of China's total iron ore imports. By contrast, more than 60 percent of iron ore imports in Europe and Japan came from the captive mines abroad owned by European and Japanese firms.[71] Hence, there was a huge incentive for Chinese metallurgical companies to engage in mineral resource acquisition and investment activities globally.

Another major commercial objective of resource investment related to asset management strategy on the part of the Chinese companies. According to a Chinese expert on China's energy and non-traditional security issues, China's overseas resource investment was not entirely (if at all) driven by a national resource acquisition strategy; rather, it was driven by an expectation of a long-term trend towards rising prices of mineral commodities and rising energy prices.[72] Chinese investors were betting on future increase in the asset values of their overseas minerals mines and energy assets. This investment motivation reflected the so-called 'resource replacement' strategy, which had been used by the Western petroleum companies seeking to expand their investment portfolio through acquisition of oil fields globally.[73] This 'resource replacement' strategy had significantly expanded the assets of companies such as BP and helped elevate their market status. Similarly, many of the overseas investment and acquisition projects undertaken by the Chinese petroleum giants and resource-related companies were essentially driven by the same logic.[74] The drop in asset values of the mines and resource companies worldwide following the 2008-09 financial crisis offered unprecedented opportunity for such resource replacement strategies, and gave added impetus to the outbound investment and acquisition spree.

Many of the investment decisions were oriented towards large-scale expansion. There was a huge incentive for the Chinese SOEs to enlarge their business empire and internationalise their operations

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[71] See: http://finance.sina.com.cn/chanjing/cyxw/20090621/00326377090.shtml; http://finance.people.com.cn/GB/8799654.html

[72] Interview: 9

[73] Interview: 9

[74] Interview: 9

both abroad and domestically, so as to avoid being acquired by their competitors.[75] This concern for survival was partly a result of fierce competitive pressure faced by the national state companies as the Chinese government was looking for ways to enhance industry concentration by encouraging and initiating mergers and acquisitions in order to nurture giant and internationally competitive state-owned corporations in key economic sectors. From the individual firm's point of view, overseas acquisitions and investment in the global resources sector were a convenient way to increase company scale and raise corporate profile.

Contrary to popular belief, the overseas corps of state-owned Chinese resource investors - the 'China Inc.' that had constantly been implied by Western sceptics - did not always act in a manner that would maximise the interests of the state. In fact, it had almost become a sore point with the Chinese government that those (national) SOEs often acted in the opposite manner. A notable phenomenon in this regard was the internecine competition among the Chinese SOEs themselves for resource projects abroad, which demonstrated the lack of collaboration and coordination among the SOEs[76] (Zhang, 2010: 195-196). Instances of competitive bidding amongst China's national SOEs in Australia for mining assets were common. Such activities had often led to higher investment costs at the expense of the Chinese bidders, thereby rendering the Chinese the big loser in the end. For instance, Wusteel, Ansteel, Baosteel and Sinosteel were reportedly competing for an iron ore asset located in the Pilbara region. By outbidding each other, they pushed up the final transaction price by as much as one third of the original price (Wu May 10, 2011).

Moreover, it had become increasingly apparent that many of the transnational overseas resource investment and acquisition activities of Chinese SOEs actually lacked clear strategic vision and long-term planning.[77] Contrary to popular belief, many ambitious investment and acquisition projects were actually the outcome of impetuous decisions; they had been carried out without a thorough risk-benefit analysis or a clear understanding of how such endeavours would help achieve the firms' long-term strategy or

[75] Interviews: 32, 39

[76] Interview: 44

[77] Interviews: 9, 32, 44

enhance their core competitive advantage.[78] As observed by some scholars, many Chinese SOE investors were neither following any government orders nor possessed a clear idea of what they were doing; they were merely 'following the crowd'.[79] The investment behaviour of the leading players in China's metallurgical industry was often 'exemplary' and could shape the investment preferences of the smaller players, which tended to be in the habit of following the behaviour of industry leaders in their search for investment opportunities. Those who acted on impulse might still be able to postulate a number of reasons such as those mentioned above to rationalise their investment decisions; but in practice, their behaviour would almost be tantamount to 'blind investment' that collectively resembled the so-called 'sheep effect' or 'herd behaviour'[80] (Dou & Tang, 2009: 191-198).

John Garnaut, the China correspondent of *The Age* and *The Sydney Morning Herald*, made some revealing remarks about Chinese fragmentation (Garnaut February 21, 2009). According to Garnaut, the widely-held yet misguided perception of a monolithic China, where the party dominated and controlled every activity, was simply an outdated and gross misrepresentation of the reality: contrary to the general impression of centralisation, China's state apparatus was highly plural and decentralised today. According to Garnaut, the Australians had got China seriously wrong with 'a kind of unthinking response, which talks about China not only like it's a simple, un-complex whole, but also a country where the Communist Party makes the decision and everybody else jumps' (Garnaut February 21, 2009). Garnaut observed that Chinese government companies, industry associations and various government agencies did not in fact act in a coordinated way; rather their behaviour often contradicted and undermined each other: China's 'sprawling family of state-owned companies can be fragmented, internally competitive and beyond the central government's powers of orchestration – however it might try' (Garnaut February 21, 2009).

With regard to Chinese government investment intentions, Garnaut believed that the Chinese system had become substantially market-oriented: the pursuit of profit was transforming China's channels and hierarchies of power and 'leaders of state-owned enterprises survive in a world of market forces and are

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[78] Interviews: 9, 32, 44

[79] Interviews: 9, 32

[80] Interview: 9

judged largely on their ability to make more money than their peers' (Garnaut February 21, 2009). With reference to Chinalco's investment motive in particular, Garnaut went so far as to claim that Chinalco 'has zero interest' in helping China's steel makers get cheaper iron ore – and the Chinese were not capable of doing so anyway (Garnaut February 21, 2009). Arguing that the 'China Inc.' was highly fragmented, Garnaut asserted that there was no cause for concern and that Chinalco would not 'attempt to subsidise its domestic competitors at the expense of itself (and the reputation of Chinese companies everywhere) by supplying them with discount Australian resources' (Garnaut February 21, 2009). In his view, even if Chinalco could buck the trend of Chinese corporate history, there appeared to be no practical mechanism for this to happen: 'Chinalco has been given the right to talk about everything but control nothing – least of all the pricing of its product' under the strategic partnership agreement between Chinalco and Rio Tinto; and if these contractual constraints did not work, the export sales will be scrutinised by the corporate regulator – the Australian Taxation Office's transfer pricing team and Rio Tinto's minority shareholders (Garnaut February 21, 2009).

Garnaut also noted that the prospects of the Chinalco bid had been severely compromised by the comments made by the chief of China Iron and Steel Association that the deal 'will help China break the duopoly in Australian iron ore supply over time' (Garnaut February 21, 2009). This comment was reported in almost every major Australian business publication as having accidentally revealed Chinalco's true intentions: to act as a stalking horse for 'China Inc.' and push down the price of Australian commodities in China's favour, and as further proof of sinister intentions behind the gathering wave of Chinese investment. Furthermore, the poor timing of sprawling investment activities undertaken by other Chinese companies also made it easier for the government to reject the Chinalco deal – by providing the option of letting other smaller deals through. The flurry of Chinese investment left an impression of an opportunistic 'Team China' raid on prized Australian resources at the bottom of the market (Garnaut February 21, 2009; Xiao & He & Bai, 2010: 141).

## 3.4 Australian Reaction against Chinese Resource Investment

### 3.4.1 The Labour Government's Stance

The Australian government appeared to have an ambivalent attitude towards Chinese investment in the country's mining sector. On the one hand, the government and mainstream politicians were sensitive to the charge of investment protectionism and resource nationalism. The Labour Party and government officials had been at pains to insist that Australia welcomed and did not discriminate against Chinese investment. In practical terms, direct investment from China did bring about tangible benefits for Australian businesses and the economy by providing much-needed capital to finance the mining operations and sustain the momentum of the mining investment and export boom in Australia, particularly in the midst of the global economic crisis. Furthermore, Canberra did not want to upset relations with Beijing, which attached great importance to its resource investment in Australia; the Labour government and key policy makers were always cautious about making policy remarks about Chinese investment, by denying xenophobia and discrimination and avoiding making overtly protectionist and hostile comments on Chinese investment.

In fact, the Australian government was anxious to defuse the heat and mounting tensions over Chinese investment. When it came to policy statements about Chinese government investment, the Labour government preferred to take a moderate stance and was careful not to allow government policy to be misrepresented or hijacked by radical politicians with nationalist and xenophobic agendas. In order to quell domestic sceptics who criticised the government for selling out Australia, Treasurer Wayne Swan was forced on many occasions to defend Chinese investment. The Treasurer and his cabinet colleagues also repeatedly reassured and explained to international investors, particularly the Chinese government, that Australia remained open for business and the foreign investment regime was essentially welcoming and not discriminatory between countries. The message was that the Labour government did not operate as a roadblock but was there to maximise capital inflow. The Treasurer also agreed with a Senate Economics Committee report that Australia's foreign investment guidelines could be better explained and had ordered the FIRB to make minor changes and initiatives to improve the agency's transparency, On the other hand, the Labour government had committed itself to undertake a series of measures to tighten the country's foreign investment regime against Chinese investment. Canberra was getting increasingly anxious about China's aggressive investment spree. Arguably, this was the true face of Labour's policy towards Chinese investment. Canberra was unnerved by Beijing's overwhelming resource ambitions. There was a deep anxiety about the prospect that Beijing could undermine the independence of the Australian resource businesses, influence the pricing of mineral exports and thus affect the profits of the Australian businesses and government revenues. As the prospect of Chinese domination loomed large, policymakers in the Labour government went to great lengths to block or restrict Chinese investment and prevent Chinese control of the country's resource assets.

These genuine sensitivities to threat, however, were always veiled and rarely enunciated in public; but they had been brought to light by two revealing U.S. diplomatic cables leaked by WikiLeaks in 2010 (Dorling March 3, 2011). According to the U.S. embassy report on the matter, titled 'New foreign investment guidelines target China', Patrick Colmer, the then Treasury's foreign investment division head and the FIRB General Manager, said that the Australian government aimed to introduce disincentives for large-scale Chinese investments. In a confidential discussion with U.S. embassy officials in late September 2009, Patrick Colmer 'confirmed to Econoff the new guidelines are mainly due to growing concerns about Chinese investments in the strategic resources sector'. Colmer's private remarks were made in the aftermath of reports that he allegedly told a Chinese investment audience in September 2009 that foreign investors with 'significant government ownership' should limit ownership stakes in greenfield resource projects to less than 50 percent and shares in major resource companies to 15 percent (Colmer September 24, 2009).

According to the leaked cable, Colmer told the U.S. officials that the FIRB 'has received more than one Chinese investment application every week this year'. Colmer was reported as saying that 'the measure is also meant to prevent complex investment schemes, such as proposals with loans that are convertible to equity, which sought to circumvent existing FIRB rules'. The comments made by U.S. officials in the cable were also revealing:

> *…(the new guidelines) clearly signal a stricter policy aimed squarely at China's growing*

> *influence in Australia's resources sector, and serves as a warning to potential investors…Thanks largely to Chinese financing, Australian companies have continued to develop the resources sector, despite the GFC (global financial crisis). Larger-scale Chinese financing may become harder to come by for these companies in the future… on the core issue, the GOA (Government of Australia) prefers to retain maximum flexibility on how it handles deals and has steadfastly resisted a clear checklist that could tie its hands. Instead, the FIRB's broad national interest mandate allows the Government considerable discretion to impose conditions on approvals.* (U.S. Embassy Canberra September 30, 2009)

According to another leaked cable, BHP Billiton CEO Marius Kloppers once had a private discussion with the U.S. Consul-General in Melbourne in June 2009 against the backdrop of intense lobbying of ministers and government officials over the proposed Rio-Chinalco deal (Murphy February 16, 2011; Dorling February 15, 2011). What Kloppers told was also indicative of the Labour government's true stance on the Chinese investment issue. Describing himself as being 'only nominally Australian' in the diplomatic cable, the South African-born BHP chief told the Consul-General that the Australian federal government 'would like to build up trade with China, but there is "real fear" of the Chinese government'. Kloppers was reported to have said that 'Australia does not want to become an open pit in the southernmost province of China' (U.S. Embassy Canberra June 5, 2009). The U.S. Consul-General reported in the cable that 'Kloppers thinks the (Australian) government is drawing a line in the sand to keep Chinese state-owned firms from owning the larger mining companies such as Rio Tinto, BHP Billiton and Woodside… He also believes Chinese state-owned firms would encounter heavy resistance should they make overtures at Australia's telecommunications and banking giants' (U.S. Embassy Canberra June 5, 2009).

### 3.4.2 Reaction from Opposition Parties

The opposition coalition by and large shared the Labour government's concern about Chinese investment. There were no major policy differences between Labour and the Liberal-National coalition on this issue. Both the government and the opposition supported the 'case by case' approach and insisted on the national interests test in reviewing foreign investment and greater scrutiny of government-related investment. In short, this was a bipartisan approach and the Liberal Party had shown solidarity with the

Labour government.

However, there was a shift of Australian politics into populist avenues on the question of Chinese investment. Some radical opposition politicians launched fierce campaign against Chinese investment, arguably with the aim of whipping up nationalist sentiment against Chinese capital. The Chinalco case provided a rallying point for the opponents of Chinese investment and a platform to launch an attack on the Labour government's handling of the Chinese investment issue. While the Labour government said a decision on the deal would be made in accordance with the national interest, Green politicians opposed outright the proposed tie-up. Almost all the submissions to the Senate Economics Committee inquiry into the deal opposed it on nationalist grounds.

Malcolm Turnbull, the Opposition leader from the Liberal Party at the time of the Chinalco deal, used his first major foreign policy speech to say the Chinalco deal was against the national interest (Turnbull May 1, 2009). Turnbull's central point was that a corporation owned by a communist regime should not be given increased influence in or control over Australia's resources; only if Chinalco was privatised should the offer be entertained. In his Lowy Institute speech of May 2009, Turnbull said China's investment strategy was to use the global crisis to acquire as many resource assets as cheaply as possible to secure its long-term supply and use such influence to reduce its contract prices. Turnbull warned that China's state-owned enterprises were seen to act in accord with Beijing's strategic goals.

Malcolm Turnbull's successor also supported careful selection and restriction of Chinese investment. Shortly after becoming the new leader of the Liberal Party in December 2009, Tony Abbott said a more stringent national interest test needed to be applied when considering foreign investments. In response to a question about his finance spokesman Barnaby Joyce's warning about doing business with government-owned entities, Abbott said, 'We think that there are some concerns when that investment is by state-owned enterprises, whether they be Chinese or any other country… In the end, what you've always got to do is to apply a national interest test. That's been our position in the past, it is our position now and it will be our position in the future' (Kelly December 11, 2009).

These remarks were made when Tony Abbott was forced to restate the coalition's support for Chinese investment in Australia after the Opposition coalition's finance spokesperson Barnaby Joyce, the National senator from Queensland and a strong critic of Chinese ownership of resource projects, called for a ban on Chinese government investment. As a Queenslander, Joyce also opposed Chinese investment in Australian coal mines and said it was 'in the long-term interest of our nation that the Chinese government doesn't own our coal'. Joyce appeared in two television commercials screened in the Australian Capital Territory (ACT) and Queensland to warn against foreigners buying the source of Australians' wealth (Coorey March 17, 2009). The advertisements came as the Treasurer extended the review period by a further 90 days to scrutinise the Chinalco bid.

Like the Labour government, the Opposition coalition chose not to adopt an explicit stance on the question and preferred to maintain a degree of ambivalence. Asked about Joyce's remarks, Abbott said the coalition welcomed foreign investment: 'it certainly is not and never has been coalition's policy to oppose Chinese investment in Australia… everyone understands that they've got to support the team position' (Kelly December 11, 2009). However, its thinly disguised fear of Chinese government investment was hard to conceal.[81] After becoming the new Opposition finance spokesman in December 2009, Barnaby Joyce stepped outside the coalition's line by calling for an outright ban on investment by Chinese state-owned companies in Australia's resources sector. Joyce warned that, although he welcomed foreign investment by private companies, investment in sovereign resources by government-owned businesses turned corporate disputes into diplomatic disputes (Uren December 11, 2009). Joyce said he was amazed at the acceptance of Chinese investment after China's arrest of Rio Tinto representative Stern Hu (Uren December 11, 2009).

Barnaby Joyce was joined by South Australian independent senator Nick Xenophon in the campaign to block Chinalco's bid, and attack on the Labour government for selling Australia's strategic assets to the Chinese government. In the same TV advertisement with Joyce, Xenophon likened the Chinalco-Rio deal to selling the resources to the Chinese government:

[81] According to observations by U.S. officials as revealed in the leaked diplomatic cable, the new Opposition was taking an even more opposing and restrictive position on Chinese government investment (U.S. Embassy Canberra June 5, 2009).

> *This isn't about stopping a takeover by a foreign company; this is about a takeover by a foreign government. As a nation, we must protect our key strategic resources. This deal is not in the national interest. You sell the milk, not the cow, and we should be selling the minerals and not the mine.* (Pepper May 9, 2009)

The Greens took a particularly right-wing nationalist slant, declaring that the Chinalco-Rio deal should be blocked on the grounds that the 'communist bosses in Beijing will exert control' over mining operations in Australia. Green senator Bob Brown launched a vocal campaign against the Chinalco bid, saying 'it is hazardous for our open and democratic nation to have the Beijing dictatorship… take control of these companies and our resources' (Perry February 18, 2009). Brown continued, 'This nation should not vest power over its future resource management in the hands of the brutally repressive Beijing bosses' (Perry February 18, 2009). He also extended his concern to China Investment Corporation (CIC) by claiming that 'there is a real danger of Chinalco's bid to control Rio Tinto today extending to the CIC's control over roads, public transport or privatised water corporations in Australia tomorrow' (Perry February 18, 2009).

### 3.4.3 Reaction from Local Politicians and Governments

By contrast, the state government and politicians on the whole were more receptive than the federal government and politicians to Chinese investment because of the tangible benefits that flowed from Chinese capital. For instance, like Western Australia, Queensland relied heavily on mineral exports and was a big host state for Chinalco. Queensland State Premier Anna Bligh urged the national government to approve the Chinalco deal to save mining jobs. She said prior to election, 'I think that the proposal between Chinalco and Rio Tinto is absolutely vital to the strength of the Queensland economy' (Kerr & Parnell February 18, 2009; Murphy February 19, 2009). Her Liberal National Party opponent had been non-committal on the issue. When Wusteel's iron ore joint venture in the Woomera Prohibited Area was turned down by the Defence Department for national security concerns, South Australian Premier Mike Rann was reportedly seeking to reverse the decision. South Australian Mineral Resources Development Minister Paul Holloway reportedly wanted the Federal Government to clarify foreign investment conditions for mines in the Woomera Prohibited Area and said the project could have been a major economic contribution to South Australia (ABC September 24, 2009).

### 3.4.4 Business Lobbies and Interest Groups

On the question of Chinese investment, Australia's business lobbies and interest groups from the mining and related industries were divided into two camps. The pro-China group included some Australian mining companies that looked upon Chinese capital and markets and those corporate advisers providing legal services to their Chinese customers seeking to invest in Australia. For instance, mining gurus such as Clive Palmer once criticised the government's handling of Chinese investment applications for being 'opaque and racist' (Garvey May 30, 2011). Some medium and small Australian resource companies were not against Chinese investment because they were keen to cultivate business ties with the Chinese companies and government. During the global financial and economic crises when debt pressure was high and widespread, Chinese capital injection and sales contracts were deemed most favourably in terms of improving cash flow, repaying debt and helping business and mining operations grow and expand. Business connections with China would enhance their long-term growth prospects and help the smaller and emerging players survive and compete with the dominant major miners. The Chinese favoured deepening partnerships with these smaller players in the Australian resources sector. This was because the growth of the emerging miners would ultimately undermine the dominant market power of Rio Tinto and BHP Billiton. However, these emerging major players and those who possessed huge and good-quality resource assets, were only looking to use Chinese capital and markets for further business expansion and profit growth; they were not willing to be acquired, absorbed, controlled or eliminated by Chinese business interests, regardless of whether they were private or state-owned enterprises.

Established dominant minerals producers such as Rio Tinto and BHP Billiton by contrast showed a much less positive attitude towards the inflow of Chinese investment in the Australian resource sector. China's resource acquisition strategy was developing into a head-on confrontation with the strategic interests of these leading mining companies, who sought to preserve their privileged market position and dominant power. The established mining giants would do whatever it took to prevent Chinese mining interests from taking root in Australia and emerging as their strategic competitors, which the Chinese were capable of doing if unchecked. BHP Billiton in particular was hostile to major Chinese investment in Australia's minerals sector. This was most notably illustrated by BHP's fierce and determined propaganda offensive and political campaigns against Chinese investment in general, and the proposed Chinalco-Rio Tinto deal of 2009 in particular, as revealed by WikiLeaks. According to the leaked U.S. diplomatic cables, BHP Billiton's senior executives had talked in private to government and national political leaders (including the Prime Minister and the Treasurer) to lobby against the Chinalco-Rio Tinto deal; and the company had also sent China-bashing emails to all senior cabinet officials and bureaucrats of all relevant government agencies talking about the 'China Inc.' stuff.

Rio Tinto shareholders' strong opposition to Chinalco's 2009 acquisition and strategic partnership offer represented a similar underlying hostility towards Chinese government capital and potential Chinese control. Some of Rio's Australian shareholders slammed the deal for handing too much control to China and were deeply concerned about Chinalco becoming involved in running Rio because it was an arm of the Chinese government, a customer and a competitor.

## 3.5 Tightening Up Foreign Investment Policy Restrictions on Chinese Resource Investment Since 2008

In 2008 the Labour government introduced a series of amendments to the Australian Foreign Investment Policy (Policy). Particularly important was the evolving stance the Policy took towards investment by foreign governments. Insofar as the expressed policy stance towards foreign government investment was concerned, the Labour government insisted that Australia had a liberal foreign investment regime that welcomed all foreign investment; that the changes were intended to clarify and enhance transparency; that they were the principles and practice that had been consistently adopted by successive Australian governments; that the case-by-case review mechanism was the right approach to maximise investment flows while protecting Australia's national interest; and that the guidelines were non-discriminatory and were applied equally to investments by all foreign government entities as they did not target or restrict investment from any particular country.

Despite government claims indicating otherwise, it was understood that 'the particular country' was unequivocally identified as China, who was the largest source of recent government investment in Australia. The successive changes that had been put in place were primarily triggered off by the inflow of Chinese government investment since 2007-08. The timings of the policy decisions closely corresponded to major developments in Chinese resource investment in Australia. Most of the measures introduced were designed to prevent Chinese state-owned or -controlled corporations from taking technical control of the Australian businesses, obtaining significant industry influence (e.g., over pricing, output and sales of specific mineral resources as consumers) or establishing dominant market positions in Australia's resources sector. Enhancement of transparency was the professed policy objective, but greater policy transparency about what were essentially policy restrictions were also intended to deter further significant investment from the Chinese government and its related entities.

The evolving content of the compulsory notification requirements and national interest considerations since 2008 was apparently directed at the characteristics of China's government-related resource investment in Australia, and reflected the preferred investment approach adopted by Chinese government investors. Analysis of the specifics of these rules suggest that the Australian government was deeply concerned about the sheer size (often involving multi-billion deals) of large-scale inflows of

Chinese sovereign investment in the Australian resources sector, as well as the strategic investment behaviour of the Chinese investors in terms of the objectives (the quest for a controlling stake or a substantial interest) and the choice of target company (major minerals producers and mining companies) and resource assets (e.g., iron ore) of their proposed investment.

### 3.5.1 2008

In response to the surge in foreign investment by Chinese government enterprises in the resources sector, against a backdrop of growing media attention on the matter, on 17 February 2008 the Treasurer announced six principles the government would consider in determining whether investments by foreign governments and their agencies were consistent with Australia's national interest:

1. An investor's operations are independent from the relevant foreign government;
2. An investor is subject to and adheres to the law and observes common standards of business behaviour;
3. An investment may hinder competition or lead to undue concentration or control in the industry or sectors concerned;
4. An investment may impact on Australian Government revenue or other policies;[82]
5. An investment may impact on Australia's national security; and
6. An investment may impact on the operations and directions of an Australian business, as well as its contribution to the Australian economy and broader community. (Swan February 17, 2008)

In accordance with the six guidelines, the government would conduct a national interest test on a case-by-case basis by considering the extent to which the prospective foreign investor 'operates at arm's length from the government' (Swan February 17, 2008). It would also examine the corporate governance practices of foreign government investors and consider whether the investor's governance arrangements 'could facilitate actual or potential control by a foreign government (including through the investor's

[82] For example, direct export of coal to the investor's refineries or power stations could lead to a loss of income tax revenue for Australia.

funding arrangements)' (Swan February 17, 2008). Proposals by SOEs that operated on a 'transparent and commercial basis' and had been 'subject to adequate and transparent regulation and supervision' would be less likely to raise national interest concerns (Swan February 17, 2008). However, investments that would impact on Australia's ability to protect its strategic and security interests, hinder competition or impact on Australian revenue policies would be closely scrutinised. The government would also examine the extent of Australian participation in the ownership, control and management of the company after being acquired by the foreign investor, including the interests of employees, creditors and other stakeholders.[83]

When releasing the guidelines, Australian Treasurer Wayne Swan stated that 'proposed investments by foreign governments and their agencies (state-owned enterprises and sovereign wealth funds) are assessed on the same basis as private sector proposals. National interest implications are determined on a case-by-case basis' (Swan February 17, 2008). However, Swan emphasised that:

> *…the fact that these investors are owned or controlled by a foreign government raises additional factors that must also be examined. This reflects the fact that investors with links to foreign governments may not operate solely in accordance with normal commercial considerations and may instead pursue broader political or strategic objectives that could be contrary to Australia's national interest.* (Swan February 17, 2008)

Although Swan claimed that these guidelines only aimed to improve the transparency of foreign investment screening process, it was clear that they were primarily aimed at the rapidly growing Chinese government investment in Australia's resources sector. In a speech to the Australia-China Business Council in July 2008, the Treasurer revealed that in the nine months following the 2007 Federal Election, the value of applications for proposed investment from mainland China had reached almost AU$30 billion (Swan July 4, 2008). That amount was three times the value for approved investment proposals in the

[83] The six principles of national interest considerations appeared as an attachment (A) entitled 'Guidelines for Foreign Government Investment Proposals' in the 'Summary of Australia's Foreign Investment Policy' released in April 2008 and in the 'Australia's Foreign Investment Policy' released in September 2009, until the substantial revision of the Policy in 2010.

fiscal years 2005-06 and 2006-07 combined, which amounted to less than AU$10 billion (Swan July 4, 2008). Given the role of the state in Chinese businesses, these applications invariably originated from China's government-owned or -supported enterprises. The Treasurer stated in his speech that foreign government investment guidelines were released with the aim of maintaining a market-based system in which companies were responsive to shareholders and in which investment and sales decisions were driven by market forces rather than external strategic or political considerations. In that July speech, the Treasurer further stressed that the 'key differences for investments associated with foreign governments concern independence, commerciality, corporate governance, and business behaviour' (Swan July 4, 2008).

While differentiating between investments in existing productive firms with developed resources and undeveloped greenfield projects in the resources sector, Swan indicated that proposals to control the existing producing firms owning developed resource assets would be closely scrutinised by the government. In particular, Swan emphasised the government's predisposition to 'more carefully consider proposals by consumers to control existing producing firms':

> *In particular, Australian governments – now as in the past – are particularly attentive when the proposed investor in an Australian resource is also the buyer of that resource or linked with the buyer of the resource. Our predisposition is to more carefully consider proposals by consumers to control existing producing firms… We usually welcome and encourage some participation by the buyer, because that offers the buyer some security of supply and the seller some stability in the market. But we need to ensure that investment is consistent with Australia's aim of ensuring that decisions continue to be driven by commercial considerations and that Australia remains a reliable supplier in the future to all current and potential trading partners… [I]t follows that as the proposed participation by a consumer of the resource increases to the point of control over pricing and production, and especially where the resource in question is already developed and forms a major part of the total resource, or where the market disciplines applying to public companies are absent, I will look more carefully at whether the proposal is in Australia's national interest.* (Swan July 4, 2008)

The Treasurer denied that the government had changed its policy to a more restrictive stance or slowed down the processing of Chinese applications: ‘I have approved a Chinese investment proposal on average once every nine days since coming into office. This is certainly not a slowing pace’ (Swan July 4, 2008). However the Treasurer acknowledged that some Chinese proposals involving ‘large or complex cases’ had required more time than the general 30-day time limit. Swan noted that in such cases, ‘for commercial reasons, most proponents prefer to withdraw and resubmit, rather than having their bid become known publicly through the gazettal of a formal interim order’ (Swan July 4, 2008).

Defending the screening regime, the Treasurer claimed that the approval timelines had been very reasonable in view of the complexity and substantially increased volume of Chinese investment proposals. Swan insisted that the regime was ‘open, in the national interest’ and ‘takes into account our responsibilities to be a reliable supplier to many different customers, and ensure the maximum development of our resource base, and a fair return for the Australian people’ (Swan July 4, 2008). The Treasurer asserted that the current case-by-case approach was preferable to formal foreign investment rules adopted by previous Australian governments in response to the issues of resource consumers investing in resource producers in the 1970s and 1980s.

### 3.5.2 2009

In February 2009, the Treasurer announced his intention to amend the Foreign Acquisitions and Takeovers Act (FATA) in response to the growing use of more complex investment structures (Swan February 12, 2009). The ministerial statement suggested that in the light of the growing use of more complex investment structures, in particular instruments such as convertible notes, the government was seeking to broaden the operation of the FATA to require compulsory notification of foreign investment proposals, where there was a possibility that the type of arrangement being used would deliver influence or control over an Australian business – whether currently or at some time in the future. The decision was taken largely in response to the use of complex instruments in the proposed Chinalco-Rio deal. Such structures and arrangements potentially would allow ownership and control events to arise in a variety of ways other than through the traditional acquisition of shares and exercise of voting power, that is, in ways which were not envisaged when the FATA was originally drafted.

The Australian government was concerned that various modern transaction structures and financing arrangements did not fall within the scope of the FATA. The proposed amendments differed from the previous regime whereby only foreign investment proposals actually exhibiting such an effect (as opposed to potentially) were notified. The proposed amendments were intended to capture those complex investment structures which might provide avenues of control beyond the traditional means through shares or voting power, and to ensure that the Treasurer's powers would apply equally to all foreign investments irrespective of the way they were structured. The amended FATA could extend the mandatory notification and screening process to a greater range of foreign investment transaction structures. In particular, equity-like financing arrangements and instruments such as convertible notes, warrants and other types of grant of equity options would be treated as equity for the purposes of the Act. On 20 August 2009, the Foreign Acquisitions and Takeovers Amendment Bill 2009 was introduced into Parliament.[84] The amendments effectively widened the scope of mandatory notification and screening.

The amendments also broadened the definition of 'substantial interest' through the introduction of the notion of 'potential voting power'. The relevant amendments took a forward-looking approach by requiring statutory notification of acquisitions of 'potential voting power' of 15 percent. Potential voting power was the notional maximum number of votes that might be cast at a general meeting of the corporation in question, including all votes that might be cast as a result of the exercise of a right (whether exercisable presently or in future, and whether on fulfilment of a condition or not). Under the previous FATA, a convertible note would generally only result in a substantial interest if it was converted; but under the FATA amendments, the issue of a convertible note might, of itself, be an acquisition of a substantial interest. This meant that the FATA would require notification where a foreign person proposes to acquire convertible notes or options over unissued shares which would confer 15 percent or more of the votes in an Australian corporation following the notional conversion or exercise of those instruments.

Indirect foreign investment in Australian assets via foreign-to-foreign acquisition by a foreign person investing in a foreign entity holding those (Australian) assets would be subject to compulsory notification

[84] The Foreign Acquisitions and Takeovers Amendment Bill 2009 received Royal Assent on 12 February 2010, and applied retrospectively from the date of the Treasurer's announcement.

under the revised FATA if the transaction would result in acquisition of a substantial interest in that Australian business. Notification would be mandatory under those circumstances if the foreign person wished to protect themselves from the prospect of the Treasurer reversing the transaction on national interest grounds. The practical implications of this change were significant. One key outcome was that a foreign company and its officers might theoretically be criminally liable if they pursued an acquisition of 15 percent of another foreign company that had Australian assets or Australian subsidiaries of sufficient value to trigger the requirements of the FATA without first notifying the Treasurer.

In September 2009, the guidelines were the subject of further comment by a senior public official. The comment, albeit undocumented, provided a rare insight into the FIRB's decision-making process (Yeates, Garnaut September 25, 2009). Speaking to the Australia-China Business Council in Sydney, Patrick Colmer, the General Manager and executive member of the FIRB, reportedly expressed the view that the government had placed a cap on the maximum aggregate foreign government ownership in Australian resource assets:

> *What we prefer to see is … various sorts of cooperative or partnership arrangements. In the resources industries and where there is significant government ownership, our Government has expressed a preference for projects which are joint projects in various forms, and in particular we are much more comfortable when we see investments which are below 50 percent for greenfields projects and around 15 percent for major producers.* (Colmer September 24, 2009)

Colmer also suggested that FIRB's preference was for the Australian companies to remain listed. However, he qualified his statement by adding that the FIRB would remain flexible and consider deals made outside Policy parameters and on a case-by-case basis. Colmer also highlighted FIRB's willingness to work with foreign investors in the early stage of their proposal and encouraged foreign investors to hold discussions with the FIRB prior to a transaction being announced.

This was not the first time that Colmer had revealed the Australian government's regulatory preference for small stake investment by foreign government investors. At the Senate Standing Committee on Economics inquiry into foreign government investment on 22 June 2009, Colmer stressed that investment proposals were examined on a case-by-case basis; however, he noted that FIRB's preference was for small stakes in large Australian resource producers and partnership or joint venture type arrangements of up to 50 percent in smaller companies (Philips & Malone 2009).

In his December speech to the Global Foundation at the end of 2009, the Treasurer commented that there had been some consistent themes emerging as to how the government considered a foreign investment proposal:

> *One – that we carefully consider cases were a proposed investor is also a buyer of the resource – in particular, where the proposal involves potential control over pricing and production;*
>
> *Two – that foreign investment in a resources company must enable Australia to remain a reliable supplier in the future to all current and potential trading partners;*
>
> *And three – that business transparency and shareholder discipline is important in promoting and maintaining sound business practices. Essentially, that we prefer to see major companies maintain their listing on stock exchanges.* (Swan December 10, 2009)

### 3.5.3 2010

On June 30 2010, the Australian government released a substantially revised version of its Foreign Investment Policy, which provided greater specific detail about how it would administer foreign investment into Australia (FIRB January 2012). The purported aim was to clarify and provide more certainty as to when foreign governments and their related entities must notify the government about a proposed investment. When it was introduced, the new Policy was widely perceived as an attempt by the government to tighten its control over Chinese investment. It basically formalised a number of practices the FIRB had adopted since 2008, and updated principles contained in policy attachments and pronounced in various policy statements and key policy speeches over that period, particularly in response to significant foreign investment into Australia's resources sector by Chinese state-owned enterprises.

There were three major changes to the Policy that had direct implications for Chinese investment in the resources sector. First and foremost there was a refinement of the national test. The new Policy replaced the six principles contained in the 'Guidelines for Foreign Government Investment Proposals' attachment with five 'New National Interest Considerations', which would apply to all foreign investments and not just investments by foreign governments. The five National Interest Considerations were:

i. National Security
ii. Competition
iii. Other Australian Government Policies (including tax)
iv. Impact on the Economy and Community
v. Character of the Investor (FIRB January 2012)

The five National Interest Considerations basically re-framed the six guidelines and raised concerns about continuing Chinese government investment. For instance, a particular concern of the new Policy was 'the extent to which an investment may allow an investor to control the global supply of a product or service'. This was exactly the same concern that had previously been underscored in the Treasurer's July speech in 2008 (Swan July 4, 2008). The emphasis that 'the investment should also be consistent with the government's aim of ensuring that Australia remains a reliable supplier to all customers in the future' was also emphasised in the Treasurer's 2008 July speech, and reflected the ongoing concern about China gaining control of products in the resources sector (Swan July 4, 2008).

Nonetheless, the five National Interest Considerations introduced a more stringent approach to the screening process. For example, competition issues would still be assessed by the Australian Competition and Consumer Commission (ACCC), but the FIRB must also assess whether a proposed investment involved 'a customer of a product gaining control over an existing Australian producer of the product, particularly if it involves a significant producer', and whether it would have an impact on the 'make-up of the relevant global industry, particularly where concentration could lead to distortions to competitive market outcomes' (FIRB January 2012). The changes reflected the government's concern that acquisitions by foreign investors must not cause issues in the export market, such as one country cornering the market in certain minerals. As to the 'impact on economy and the community consideration', in addition to the concerns described in the old Policy, the FIRB would also consider the extent to which the investor would develop the project and ensure a ‘fair return for the Australian people’ (FIRB January 2012).

The issue of foreign government investment was singled out and given separate treatment in the new Policy under the section ‘Foreign Governments and Their Related Entities’ (FIRB January 2012). Under the new Policy, where a proposal involved a foreign government or a related entity, the government would consider:

> *…if the investment is commercial in nature or if the investor may be pursuing broader political or strategic objectives that may be contrary to Australia’s national interest. This includes assessing whether the prospective investor’s governance arrangements could facilitate actual or potential control by a foreign government (including through the investor’s funding arrangements). Proposals from foreign government entities operating on a fully arms length and commercial basis are less likely to raise national interest concerns than proposals from those that do not. Where the potential investor has been partly privatised, the government considers the size, nature and composition of any non-government interests, including any restrictions on the exercise of their rights as interest holders. The Government looks carefully at proposals from foreign government entities that are not operating on a fully arms length and commercial basis. The Government does not have a policy of prohibiting such investments but it looks at the overall proposal carefully to determine whether such investments may be contrary to the national interest.* (FIRB January 2012)

The document contains much more detailed and specific elaboration of the relevant treatment of government investors in comparison with what was provided in the old Guidelines for Foreign Government Investment Proposal (FIRB January 2012; Swan February 17, 2008). The changes introduced a more stringent regulatory approach to handling Chinese government investment in the resources sector. Insofar as government investment in a major Australian resource company was concerned, only if the investment was truly passive with no control elements attached (in particular the right to appoint a director), would it be deemed acceptable by the Australian authorities.

The new Policy also expressly set out a range of mitigating factors designed to help determine whether proposed investments were compatible with national interest. These factors, which were not mentioned in the previous Policy, included:

i. The existence of external partners or shareholders in the investment;
ii. The level of non-associated ownership interests;
iii. The governance arrangements for the investment;
iv. Ongoing arrangements to protect Australian interests from non-commercial dealings; and
v. Whether the target will be, or remain, listed on the ASX (Australian Securities Exchange) or another recognised exchange. (FIRB January 2012)

### 3.5.4 Typical Case Scenarios of Selective Restriction on Chinese Investment

Although the Australian government tightened the foreign investment regime against Chinese investment, instances of formal rejection were rare. Indeed, approval was granted for the overwhelming majority of proposed Chinese deals in the resources sector. Between the 2007 and 2010 financial years, the Australian government approved over AU$400 billion of proposed foreign investment into Australia; over AU$70 billion of this total was from China and channelled through more than 280 individual transactions (Handley 2011). There were 230 investment approvals for Chinese investment from November 2007 to mid-2011, only six with conditions attached; and there had been no rejections over this period (Larum June 24, 2011; Larum, 2011). Despite tightening of the screening process, actual Chinese direct investment still increased threefold since 2009; in 2010, China was the sixth-largest source of new investment to Australia; and Australia remained China's number one direct foreign investment destination, aside from Hong Kong (Larum June 24, 2011).

In fact, the various 'caps' were not applied rigidly and there were instances where approval was given to proposed investments seeking a controlling stake. Notable examples include: Sinosteel Corporation's takeover offer for 100 percent of Midwest Corporation in 2008,[85] Yanzhou Coal's full takeover bid for Felix Resources in 2009,[86] China Minmetals' takeover offer for 100 percent of OZ Minerals in 2009,[87] Zijin Mining's offer to acquire 100 percent of Indophil Resources in 2009,[88] PetroChina's acquisition of 100 percent of Arrow Energy through a 50/50 joint venture with Shell Energy Holdings in 2010,[89] and Hunan Non-ferrous Metals' buyout of Abra Mining in 2011, following its first acquisition of a 70 percent shareholding interest in Ara Mining in 2008.[90]

Other cases where formal approval was granted to proposed Chinese investment acquiring a majority interest in a target Australian business include: China Petrochemical's (Sinopec) acquisition of a 60 percent joint venture interest in the assets held by AED Oil in 2008 (the first ever Chinese acquisition of oilfield in Australia);[91] Shagang Group's (Shasteel) acquisition of 73.9 percent of Grange Resources in 2008;[92] China Uranium Development Company's A$100 million bid for 70 percent of emerging Australian uranium company Energy Metals (EME) in 2009 (the first ever Chinese acquisition of uranium mine in Australia);[93] Shenzhen Zhongjin Lingnan Nonfemet's acquisition of 50.1 percent of Perilya Limited (PEM)

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85 Source: 'Sinosteel Builds Stake in Midwest' (June 5, 2008) http://www.ft.com/cms/s/0/c7870ee8-3299-11dd-9b87-0000779fd2ac.html#axzz2yQMwkVp6

86 Source: 'Yanzhou Coal May Sell Stake in Felix Minerva' (July 17, 2010) http://en.sxcoal.com/Search.aspx?category=news&keys=Felix

87 Source: 'Foreign Investment' (March 27, 2009) http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/029.htm&pageID=003&min=wms&Year=&DocType=

88 Source: 'Zijin Mining bids for Australia's Indophil Resources' (December 03, 2009) http://www.intellasia.net/zijin-mining-bids-for-australias-indophil-resources-114879#sthash.rNd7zvOR.dpuf

89 Source: 'Shell and PetroChina Complete Arrow Energy Acquisition' (August 23, 2010), http://www.shell.com/global/aboutshell/media/news-and-media-releases/2010/arrow-acquisition-complete-240810.html

90 Source: 'Chinese and Australian Authorities Approved Hunan Non-ferrous Acquisition of Australian Mining Assets' (September 12, 2008) http://www.cnstock.com/paper_new/html/2008-09/12/content_64466745.htm

91 Source: 'AED Oil Calls in Administrators' (August 15, 2011) http://www.theaustralian.com.au/business/mining-energy/aed-oil-calls-in-administrators/story-e6frg9df-1226115092624

92 Source: 'Grange Resources to Acquire Australian Bulk Minerals' (September 25, 2008) http://www.theaustralian.com.au/news/grange-abm-agree-to-718m-merger/story-e6frg6n6-1111117580458

93 Source: 'Northern Uranium China Deal May Face Australian Regulatory Hurdles' (August 4, 2010) http://australianuraniuminvesting.blogspot.co.uk/2010_08_01_archive.html

through share placement in 2009;[94] and China Metallurgical Group (MCC)'s acquisition of majority shareholding in Cape Lambert Iron Ore in 2008.[95] All of these transactions proceeded smoothly with FIRB approval.

There were also cases where acquisitions of more than 15 percent stake in major producers went ahead without raising official objections from the FIRB or the Treasury. For example, Baosteel's proposed acquisition of 15 percent stake in Australia's fourth largest iron ore producer Aquila was granted in 2009; the transaction rendered Baosteel the second largest shareholder of Aquila. Approval was also given to Baosteel by the FIRB to subsequently raise its maximum shareholding in Aquila to 19.9 percent. Other examples include Hunan Valin Iron & Steel Group's purchase through share placement of 17.34 percent stake in Fortescue Metals Group (FMG) in 2009 (which rendered Valin the second largest shareholder of FMG),[96] and Anshan Iron & Steel Group (Ansteel)'s acquisition of an additional 23.68 percent shareholding through share placement in Gindalbie Metals in 2009 (which resulted in total ownership of 36.28 percent of Gindalbie share capital and rendered Ansteel Gindalbie's biggest shareholder).[97]

These examples show that the Australian government was not prohibiting Chinese investment in resources altogether. Thus, it is important to keep accusations of 'Australian discrimination' against Chinese resource investment in perspective. However, this data and specific cases may not necessarily provide an appropriate benchmark against which the Australian government's true attitude towards Chinese (government) investment in the resources sector should be measured. These approved cases only reflect the specific circumstances of the individual investment proposal. It is true that the national interest test was being conducted with a degree of flexibility and discretion for each individual case; but it

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[94] Source: 'Australian Acquisition Proves Rich Seam for SZLN' (July 7, 2009) http://www.chinadaily.com.cn/cndy/2009-07/07/content_8385519.htm

[95] Source: 'Australia Gives the Green Light to MCC Acquisition' (June 16, 2008) http://companies.caixin.com/2008-06-16/100050961.html?NOJP

[96] Source: 'China's Valin Iron and Steel May Cut Stake in Fortescue Metals Group' (December 31, 2011) http://www.theaustralian.com.au/business/mining-energy/chinas-valin-iron-and-steel-may-cut-stake-in-fortescue-metals-group/story-e6frg9df-1226233569637

[97] Source: 'Protecting China ODI – Minority Shareholder Rights' (January 2010) http://www.asialaw.com/Article/2371301/Protecting-China-ODIminority-shareholder-rights.html?Print=true&Single=true

was also an established fact that significant restrictions had been imposed on Chinese investment by the Australian federal government.

The Labour government was sensitive to the charge of investment protectionism. That Australia could never afford to shield its economy from foreign investment was a bipartisan policy upheld by successive governments, and its significance was very well understood by the Labour government. Indeed, the government had taken a rather cautious approach towards the screening of Chinese government investment in the resources sector. Rather than trying to insulate the resources sector from Chinese capital, the Australian government's approach was to strategically restrict Chinese government investment, by allowing the needed and the beneficial to come in while fending off or limiting those that were deemed suspicious and detrimental to Australian interests.

*Potential Applications Being Deterred*

In practice, very few proposals were formally rejected by the Treasurer. What the figures do not and cannot show, however, is the number of Chinese investment proposals which had been 'deterred' by the stringent foreign investment rules. For instance, some Chinese investors saw the 15/50 caps as an unacceptable line in the sand and accordingly gave up the idea of investing in Australia. On the face of it, that the formal rejection rate was low seemed to suggest that the investment review process was not particularly restrictive. However, the data does not really allow us to make a fully informed assessment, mainly because we do not know how many investment interests were not submitted for review, which would otherwise have flowed into Australia if they had not been discouraged by the prevailing investment regime.

*Informal Rejections and Withdrawal of Applications during Early Consultation*

There have reportedly been a large number of cases where the Chinese investors opted to withdraw their investment proposals after being explicitly told by the FIRB that their proposals were likely to be considered contrary to the national interest, and therefore unlikely to be approved by the government (Economic and Commercial Section June 22, 2011). This often took place during the initial informal consultation phase, even before the Chinese investors formally submitted their investment proposals to the FIRB. The FIRB always advised prospective foreign investors to initiate informal dialogue with them regarding their investment proposals before the formal submission of their investment applications. A large number of Chinese investment proposals had reportedly been discouraged and withdrawn at this stage.

According to official Chinese government sources, during the period from November 2007 to January 2011, 53 Chinese government investors withdrew their investment proposals prior to a formal decision being made by the Australian government;[98] Chinese investors made up more than a quarter of all the investors that had withdrawn their investment applications. According to other sources, 521 out of a total of 8548 applications had been withdrawn during the 2007-2008 period alone (FIRB 2009). This proportion seemed significant compared with the 0.1 percent formal rejection rate. These figures, however, cannot be verified.

*Withdrawal after Formal Submission of Applications*

There were also Chinese investment proposals that had been withdrawn after investment applications were formally submitted. In that way, the investment proposals were also effectively blocked without having been formally rejected. The Chinese investors were given feedback on their proposals from FIRB or Treasury officials during the formal review process and were advised to make the necessary revisions and re-submit their proposals. Under those circumstances, it was not rare for an applicant to withdraw its proposal after receiving government advice that the acceptance of the proposal would be subject to stringent conditions that were unacceptable to the investor. There were also cases where applicants had made repeated efforts to meet the requirements of the authorities by revising the original investment application in accordance with the official recommendations received and re-submitting the revised proposals as instructed by the FIRB, but still opted to withdraw in the end after the FIRB repeatedly raised the bar and imposed even more stringent conditions which were deemed contrary to the original investment purposes. China Nonferrous' failed acquisition of Lynas Corporation in September 2009 was

[98] Source: 'Data Shows Chinese SOE Investment Turned Away By Australian FIRB's Rules' (July 27, 2011) http://shangwutousu.mofcom.gov.cn/article/ddgk/zwminzu/c/201107/20110707665392.shtml

a typical example in this regard (Li October 23, 2009; Garnaut October 15, 2009; Yi November 15, 2010).

*Deferred Government Decision*

The Australian authorities would postpone their review decision in cases involving certain large and complex investment projects, which would require more time to review and assess the investment proposals than the normal 30-day time frame allowed. However, when dealing with politically thorny and diplomatically sensitive investment proposals, especially when an outright rejection might be diplomatically inconvenient or politically contentious (e.g., inviting allegations of investment/resource protectionism), the Australian government would also arbitrarily choose to postpone its decision rather than immediately reject the application altogether[99] (Garnaut May 21, 2009; Murphy & Garnaut June 5, 2009; Freed June 5, 2009). In that scenario, some Chinese investors would prefer to withdraw their applications.

However, some more determined investors would resist government pressure to significantly revise the investment proposals by insisting on the original investment plans and refusing to make any substantial compromises. Under those circumstances, the government would continue to withhold the formal decision and issue an 'interim order' accordingly. This would usually lead to two outcomes: either the applicants were left with no other options but to withdraw their applications eventually, or the proposed transactions lapsed or were shot down by the changing business circumstances as a result of the postponement. The most notable case in this regard was Chinalco's failed attempt to forge a strategic partnership with Rio Tinto in 2009.[100] It was reported that repeated delays in foreign investment approvals by the federal government were causing 'significant and damaging misconceptions' in Beijing; and according to investment lawyers, some of their Chinese clients were dropping their investment

[99] In his July speech in 2008, the Treasurer noted that some Chinese proposals involving 'large or complex cases' had required more time to review than the general 30-day time limit; Swan admitted that in such cases, 'for commercial reasons, most proponents prefer to withdraw and re-submit, rather than having their bid become known publicly through the gazettal of a formal interim order' (Swan July 4, 2008).

[100] Another example would be Shousteel's failure to acquire a 19.99 percent stake in the Australian gold and iron ore miner, Prosperity Resources, in 2008. The AU$4.5 million subscription agreement lapsed after failure to obtain FIRB approval by the agreed deadline. Source: 'FIRB Halts Shougang-Prosperity Deal' (July 3, 2008) http://www.bestemployers.com.au/article/FIRB-halts-Shougang-Prosperity-deal

applications believing they were unwelcome. It was widely believed amongst the Chinese that the approval delays revealed the true position of the Australian government, contrary to public assurances by senior ministers and the Prime Minister (Garnaut April 29, 2008).

*Rejections by the Defence Department for National Security Concerns*

There were a few Chinese government investment bids that were blocked not by the FIRB or the Treasurer, but by Australia's national security establishment, most notably the intelligence agencies and the Department of Defence. Proposed investment projects might cover defence-sensitive mining areas and require the necessary security clearance. Under such circumstances, the FIRB and the Treasury would always require the investment applicant to secure an approval from those security agencies (in practice, only the Department of Defence would directly deal with the investors) before beginning to review such investment proposals. If the Department of Defence rejected the investment project for national security reasons, that would save the FIRB or the Treasury the trouble of turning the application down by itself if the proposed investment was deemed contrary to national interest. Sometimes the FIRB would still give the green light to the proposed investment but only under the condition that the defence-sensitive mining area must be abandoned and excluded from the investment package. Nevertheless, rejections by the Department of Defence were not included in the number of rejected cases officially registered on the FIRB's record (La Canna September 23, 2009; Murchpy September 24, 2009; Faulkner September 23, 2009; Burke May 4, 2011).

*Compromised Investment Proposals*

The FIRB figures tell us very little about how many approved investment proposals were deliberately structured in a way to reduce the risk of rejection. Some investors would take the initiative to structure their investment in accordance with some of those 'mitigating factors' in order to facilitate their clearance through the review process and enhance the approval prospects for their investment applications. Those investment applications were designed to meet the various requirements as set out by the Policy and would otherwise have taken on a significantly different structure if there had not been such stringent regulatory restrictions imposed. The more experienced investors would have known the Australian government’s regulatory preferences and understood that any ambitious strategic investment applications would be bound to come under the very close scrutiny of the foreign investment authorities, and would likely fail the national interest test.

Many of the joint ventures between the Chinese steel mills and the Australian resource companies for iron ore projects were conspicuous examples in this regard. Most of the iron ore exploration and development joint ventures established since 2007 had followed Patrick Colmer’s ‘50/50’ rule. Because the risk of FIRB/Treasury objection remained their biggest concern, the increasingly risk-averse Chinese steel mills had scaled down their ambitions by voluntarily avoiding going over the 50 percent limit (on Chinese ownership). In such joint ventures, both the Chinese and the Australian parties would structure their investments in accordance with the rule by dividing the ownership of the joint business into equal partnerships. The Chinese investors caution not to exceed the 50 percent bottom line, lest the entire deal be rejected by the Australian authorities, may well have been the reason for the rather frequent occurrence of the 50 percent cap placed on Chinese ownership. Indeed, this seemed to follow a similar pattern (not least across most of the major iron ore joint ventures) as observed after 2007, since the preferences of the Australian government had become clearer and better understood.

For instance, in the Wusteel-WPG deal, executive director of Western Plains, Heath Roberts, reportedly said the transaction was deliberately structured to allow for the constraints of foreign ownership within the Woomera Prohibited Area. In response to the Defence Department’s decision to reject the proposed joint venture with the Chinese partner, the WPG executive director emphasised that the proposed deal deserved a better outcome and ‘ought to have been considered differently’ because the proposal allowed the ‘Chinese group WISCO (Wuhan Iron and Steel Corporation) (to) acquire 50 percent only of the project’ and ‘had some critical checks and balances to see that the Defence's interests weren't jeopardised’ (ABC September 24, 2009). Wusteel had also forged joint ventures on the 50/50 basis with Centrex Metals (CMX) to develop the Eyre Peninsula project in 2008 and entered into an agreement with CMX to jointly build the iron ore Sheep Hill Port and Spencer Port in 2009 and 2012 respectively. Ansteel established a 50/50 joint venture in 2007 with Gindalbie Metals to develop the Karara project in the

Mid-West region in Western Australia.[101] Baosteel in 2007 signed a 50/50 joint venture agreement with Fortescue Metals Group to jointly develop FMG's iron ore mines in the Pilbara region in Western Australia.[102] The main point is that the scale of Chinese investment in these cases had arguably been reduced by the self-restrained approach adopted by Chinese investors as a result of the restrictive foreign investment Policy. The extent of this voluntary scaling-back on the part of the Chinese investors is hardly quantifiable.

*Conditional Approvals*

Government interventions to restrict Chinese investment and prevent Chinese control also took the form of the imposition of compulsory conditions on individual investment proposals. A number of the investment approvals were subject to stringent conditions on ownership requirements and corporate governance practice that reflected specific national interest concerns and aimed to limit Chinese control over Australian businesses. In such cases, Chinese investors were forced to accept strict conditions imposed by the foreign investment authorities by altering their investment plans accordingly in order to secure government approval. Such cases of conditional approvals were not rare. Indeed, some corporate advisors hired by Chinese investors observed that imposing undertakings on Chinese SOEs had in fact become the rule, rather than the exception under the Labour government.[103] However, the number of such conditional approvals was not fully disclosed by the relevant Australian authorities.

There have been a number of notable cases of conditionality in relation to the approval of Chinese investment transactions in recent years. The flexible application of stringent self-restrictive conditionality was generally aimed to address the following two broadly defined concerns: whether the Chinese SOEs sought control over the Australian business and/or intended to act in an organised way with one another

[101] Source: 'Iron Ore - Gindalbie and AnSteel agree on Karara project' (2007) http://www.asiaminer.com/64-news-archive/2007/july-2007/769-iron-ore-gindalbie-and-ansteel-agree-on-karara-project.html#.U0XCTOpOV6o

[102] Source: 'Baosteel and FMG Signing an Agreement on a Joint Venture of Iron Ore' (August 30, 2007) http://www.baosteel.com/plc_e/02news/ShowArticle.asp?ArticleID=1032

[103] However, according to other sources, very few proposed Chinese investment transactions had any onerous conditions placed on them as the essential preconditions for approval. Of the few transactions that had conditions attached, all were investments originating from government-related entities and all had special circumstances that necessitated conditions being applied.

and with downstream users of commodities to distort the market for those commodities; and whether the application possessed any national security or strategic implications, such as the above-mentioned Wusteel-WPG deal and the Minmetals-OZ Minerals deal, etc, (Swan July 9, 2010). Instances of conditionality reflecting industry and competition concerns were much more common (Swan August 24, 2008; Sherry October 23, 2009; Swan March 31, 2009; Swan April 23, 2009). Government rulings in this regard tended to address such issues ranging from corporate structure to conflict of interests concerns. Some were imposed to prevent Chinese investors from 'colluding' with each other and with the downstream users of commodities in China to distort the market at the expense of the Australian businesses. Others were designed to forestall 'Sinolisation' of Australian businesses.

## 3.6 Chinese Misgivings about Australian Discrimination

Chinese investors and government officials were deeply sceptical about the Australian government's assertion that it was genuinely welcoming to Chinese investment.[104] In fact, they had serious concerns about perceived Australian discrimination against Chinese investment. The successive adjustments in Australia's foreign investment policy, such as the six guidelines on foreign government-related investment introduced in early 2008, were widely regarded as discriminatory against the Chinese.[105] Their practical impact demonstrated beyond doubt who those measures were aimed at (Larum June 24, 2011). The Chinese government recognised Australian concerns about excessive foreign control of Australian resources by any single country; but it also expected its Australian counterparts to recognise the fact that China already possessed a market economy and Chinese SOEs were independent market entities, many of whom were publicly listed companies not only at home but globally.[106] This theme was repeatedly emphasised by Chinese officials in response to the question of Chinese SOE investment.

In fact, Chinese government officials were sceptical of foreign concerns about the government background of Chinese investment. According to Li Rongrong, the Chairman of the SASAC, the issue was used as an excuse to block or restrict Chinese foreign direct investment. Li also attributed foreign scepticism to prejudice against Chinese SOEs and ignorance about their development needs and their corporate structure (Ye July 6, 2009). Chinese business leaders were very vocal in their criticism of the Australian government's approach. For instance, at a lunch hosted by the Australian ambassador Geoff Raby in April 2011, several Chinese executives reportedly told the visiting Prime Minister, Julia Gillard, of their concerns about the FIRB, labour laws, environmental regulations, and various approval processes. Shen Heting, chairman of China Metallurgical Construction, put his criticisms on record. None mentioned the carbon or resource rent taxes to Gillard as they were focused on more pressing things. In May 2009, Luo Tao, chairman of China Nonferrous Metals, complained of 'biases against Chinese investors' (Garnaut May 31, 2011).

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[104] Interview: 44

[105] Interviews 8, 44, 70

[106] Interview: 70

The Chinese side felt that the Australian government was not forthcoming in its communication of any foreign investment policy changes to the Chinese government and investors, who were often left in the dark about Australia's foreign investment policy adjustments when they were announced;[107] and investors were often left clueless about the Australian government's preferences and official attitude towards major Chinese investment applications during the review and approval process. For instance, the Chinese government had grave misgivings about the failure on the part of the Australian government to communicate to the Chinese the six guidelines on foreign government-related investors, which were taken by the Chinese government as new arrangements specifically targeted at Chinese investors despite Australian claims otherwise. These guidelines were introduced without any prior notification, let alone any consultation with the Chinese government, which was the largest stakeholder and yet was taken by surprise by the big policy move.[108]

Nor did the Chinese believe that the Australian federal government had been an innocent bystander, as was claimed by the Labour government amidst a number of failed high-profile Chinese investment cases.[109] Most notably, few Chinese believed that the Rudd government had been a neutral party during the breakdown of the Chinalco-Rio deal, and the subsequent merger between the iron ore businesses of Rio Tinto and BHP Billiton. Although the Australian government asserted that it did not have a hand in the process and the outcomes were solely the business decisions of the firms, the Chinese could hardly accept this claim. The Chinese government even suspected the Australian government of deliberately disclosing details of Chinese investment proposals and acquisition bids to the press for the purpose of instigating public debate and setting off media sensationalism against Chinese investment, so that Canberra could discourage and/or delay the proposed Chinese investment on the pretext of political pressure and public resistance towards the Chinese investment deal.[110] The Chinese government reportedly preferred to be dealt with in private and was furious with the Australian government and media

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[107] Interviews: 44, 70

[108] Interview: 70

[109] Interviews: 7, 70

[110] According to Duncan Calder, the Western Australian president of the Australia China Business Council, once the deal became public, it became difficult for the (Australian) government to respond; if issues had been negotiated discreetly beforehand, less of the overall bilateral relationship would have been exposed and thus placed at risk (Callick June 6, 2009).

when debates over major Chinese investments, such as the Chinalco-Rio deal, played out in public arena and greatly compromised the prospects of Chinese investments in Australia (Callick & Sainsbury October 27, 2009).

A sense of suspicion was pervasive in the Chinese discussions around Australian discrimination towards Chinese resource investment since 2009. The Chinese discourse mainly arose in the context of discussions about the political difficulties facing China's outbound resource-related investment. There were few thorough studies in China of the issue of Australian discrimination against Chinese (resource) investment. However, numerous media commentaries had been made on the issue by business journalists, investment experts and scholars. Notably, the high-profile Chinalco-Rio investment deal in 2009 generated a lot of reflective discussions focused on the Chinese investment experience in Australia, and the important lessons drawn from the case for China's overseas (resource) investment. The Chinalco case was seen as a typical example illustrating the investment dynamics and political environment for Chinese investors in Australia.

Foreign academic literature on Chinese perceptions of Australian discrimination against Chinese investment is also rare; but numerous journalistic accounts are available of this sentiment in the Australian media (Garnaut April 29, 2008; Korporaal July 2, 2008; Garnaut May 31, 2011; Larum June 24, 2011). The findings of some business reports produced by Australian investment lawyers and accounting firms testified to this sentiment amongst the Chinese. The Australian government's approach to Chinese investment was also labelled by some corporate lawyers as 'opaque and guess work'. John Larum's report offered a rather thorough account and systematic summary of Chinese perceptions of Australian discrimination, based on extensive interviews in Australia and Beijing in early 2011 (Larum, 2011).

Larum's study suggested that the Chinese regarded Australia as an attractive investment destination. However, many Chinese investors believed that Australia was a more difficult place to invest in compared with other countries. Chinese investors and officials believed that the FIRB and the Australian government in general discriminated against China, particularly with regard to ownership restrictions for natural resource investment. Larum noted that the Australian government's approval process for foreign investment was overwhelming the focus of Chinese complaints. He went on to say that investments in other sectors were generally uncontroversial, with the exception of agricultural land (Larum, 2011).

The report underlined a number of points which Larum's interviewees raised when asked about evidence for discrimination. In general the evidence they provided dealt with the following five issues. First, developments in Australian foreign investment regulatory rules since 2008 were perceived by the Chinese as new and directed against Chinese investor/investment. Undocumented policy guidelines on foreign government ownership caps, such as Patrick Colmers' 'informal' yet targeted comments in 2009 about acceptable levels of foreign government ownership in equity (15 percent) and greenfield (50 percent) investment, were perceived as targeted at Chinese investors. Despite the FIRB's denial of policy change, this sensitive policy deliberation was generally interpreted by Chinese investors and officials, alike, as a major policy change in the foreign investment regime. Second, the report noted that the Chinese felt that the FIRB review process was not effectively managed. Proposals made by Chinese government investors were subject to excessive scrutiny by the Australian authorities whereby the review process was slow, inefficient, uncertain, and opaque. Third, the failure of a number of huge and highly publicised Chinese investment proposals also reinforced the perceived unwelcoming attitude of Australians towards Chinese investment. Larum's report highlighted the three high-profile cases that were deemed most notable in this regard. These were the Chinalco-Rio Tinto deal, the China Nonferrous-Lynas deal and the Minmetals-OZ Minerals deal, respectively. In the view of many Chinese investors and officials, the failures or problems encountered by Chinese investors in these cases would not have arisen for a non-Chinese investor. Fourth, according to the Chinese investors and officials interviewed, the Australian media played a negative role in scaremongering around Chinese FDI into Australia. This negative media attention was seen as influencing popular opinion and government policy by demonising Chinese investment and government. Finally, Chinese suspicion of the Labour government's discriminatory foreign investment policy received some empirical support in the form of the WikiLeaks report of a cable from the U.S. Embassy in Canberra. The leaked diplomatic cable relayed comments made by a senior FIRB official (Patrick Colmer) that the additional measures were 'aimed squarely' at China (Dorling March 3, 2011).

### 3.6.1 Chinese Distrust of Australian Policy Intention

As to the motivations behind Australian discrimination against Chinese investment, Larum's report suggested that Chinese investors and officials gave no consistent response, although there were some recurring and overlapping themes, such as: Australian protectionism/nationalism; suspicion of China because it is a communist country; concerns about Chinese state ownership of Australia's resources (especially when both an owner and customer); subsidised Chinese state financing (via Chinese banks); concerns about China's growing economic strength; and related to that, Australia playing a part in a U.S.-led strategy to contain China (Larum, 2011).

The Chinese discussions that emerged since 2009 also suggested a wide array of Chinese opinions about the causes of Australian discrimination. The Chinese had some rather heated discussions about the collapse of the Chinalco-Rio deal; many of the Chinese post-mortems on the failed deal were very revealing in this regard. The problem of Chinese foreign direct investors' government background constitutes a potentially sensitive topic.[111] Nevertheless, many Chinese observers acknowledged that it had become a significant barrier for outbound Chinese investment and resource acquisition abroad. Zhang Guangrong, an expert on China's resource-related outbound direct investment from the Chinese Academy of International Trade and Economic Cooperation (CAITEC) affiliated with the Commerce Ministry, recognised the growing anxiety of many host governments about the national security implications of state-owned (or sovereign) foreign investors. Zhang's work, which was one of the most thorough studies of China's outbound foreign direct investment in the resources sector, suggested that state-ownership and government background of the Chinese investors were thought to have been an important factor contributing to Western scepticism (Zhang, 2010: 125). Reflecting on the failure of the Chinalco deal, Chen Daofu and Su Yang believed that China's overseas resource investment would inevitably face foreign resistance given the government background and state-ownership of Chinese investors. As both authors were from the Development Research Centre of the State Council, their analysis reportedly provided a revealing insight into the official views of the Chinese government (Chen & Su, 2010a, 2010b). Xing Houyuan, who was a prominent scholar on Chinese overseas investment and headed the Research Centre of China's Overseas Investment at the CAITEC, suggested that one major

[111] Interview: 8

reason for the setbacks in the overseas acquisition attempts by some of China's national SOEs in the West, was that their investment had been subjected to strong political interference as their government identity and state-ownership were called into question and deeply resisted by the Western host countries, which by and large were welcoming Chinese investment in government bonds only, but not their resource assets or most-valued core companies (Gong June 15, 2009).

However, a closer look at the Chinese sources suggests that many Chinese had serious doubts as to whether the government background of (Chinese) sovereign investors was the true or the most significant source of Australian concern. What seemed to have had the most sway over Chinese elites were in fact other political considerations. Many believed that it was not so much about the growing anxiety over state-ownership of foreign investors *per se* as other political factors. They rejected the concern over government investors, claiming that it was merely a pretext for other politically-motivated reasons to limit Chinese investment in Australia.[112] This entrenched perception was suggestive of the deep distrust of Australian attitude towards Chinese investment.

For instance, some Chinese scholars and officials were receptive to the idea that the real source of resistance to Chinese investment was Australia's growing resource nationalism. Hou Minyue, who was a leading Chinese scholar of China-Australia relations, argued that the government background of Chinese SOEs was merely the most ostensible reason for Australian concerns; the real source of the country's anxiety was strong economic nationalism that had been surging in Australia in the face of overwhelming Chinese resource investment. According to his interpretation of the events, Australian concerns about the government background of Chinese investors were nothing more than a superficial phenomenon, if not a convenient excuse used by the Australians to block or restrict Chinese capital in the resources sector. In Hou's opinion, the real problem for the Australians was not so much the state-ownership or government identity of the Chinese investors, as resource security-related economic nationalist anxiety in response to the surging Chinese resource investment in the country (Hou, 2010).

Others were inclined to view the anti-Chinese sentiment and partisan politics as the most fundamental

[112] Interviews: 33, 43, 44, 45

factor, believing that investment discrimination was consistent with the perceived broader unfriendliness towards and 'demonisation' of China by the Australian media and politicians. Guo Chunmei, an analyst of Australia-China relations based at China Institutes of Contemporary International Relations (CICIR), emphasised the constraints on domestic politics faced by the Australian policymakers in dealing with Chinese investment. Guo argued that Kevin Rudd was in a difficult position on the question of Chinese investment as he was very much tied down by partisan politics on the question of Chinese investment for fear of being attacked by political opponents for being pro-China, or being labelled by the media as too soft on the investment issue vis-à-vis the Chinese. Guo noted that Kevin Rudd was susceptible to the sway of growing anti-Chinese popular and political sentiment in Australia, to which Rudd's policy on Chinese investment had been held hostage (Ma June 11, 2009; Ifeng TV June 25, 2010).

Mei Xinyu, who was a research fellow of the CAITEC and an active media commentator, also had significant misgivings about the adverse impact of Australia's anti-China partisan politics on Chinese investment. As to the specific example of the Chinalco case, Mei unequivocally argued that the deal was killed essentially by political considerations that led to deliberate delays in the government review process that allowed Rio to wait for the markets to recover, and help set Rio on its feet again accordingly (Cai July 10, 2009; Cai & Chen & An June 11, 2009; Ma June 11, 2009). Mei believed that the Australian opposition parties were keen to demonise China and to play up the fear of the Chinese threat, thereby forcing Rudd to distance himself from China in the face of extreme anti-Chinese political sentiment. The decision to extend the review process for the Chinalco deal, the initial rejection of the Minmetals-OZ Minerals deal on national security grounds, and the strict conditions imposed on Valin's acquisition of interests in FMG, all testified to Rudd's attempt to dissociate his government from playing into Chinese interests (Mei June 8, 2009; Mei June 7, 2009).

Indeed, many Chinese believed that Australian discrimination stemmed from hostility towards China, as some sections of Australia's ruling elite still adopted a Cold War mentality and perceived China's rise as a threat in all respects.[113] There were also views that attributed Australian discrimination to political bias against a communist country/regime on ideological grounds. Some Chinese voices even drew great

[113] Interviews: 7, 33, 45

attention to the geo-strategic factors, by suggesting that the U.S. factor had come into play and Australia was just playing a part in a U.S.-led strategy to contain China by blocking and restricting Chinese investment. For example, Mei Xinyu asserted that the involvement of ‘external forces’ – presumably the United States – had further complicated the issue: had Australia been able to make an independent choice without the American influence, the controversy over Chinese investment would not have escalated into such a serious political issue. Mei blamed China’s hurdle on the Americans and the pro-U.S. elements in Australia who were fanning the flames of anti-Chinese sentiment and seeking to lock Australia into America’s orbit in containing China. Whilst recognising that the government identity of the Chinese SOEs had become an easy target for Westerners hostile to Chinese capital and constituting a topic vulnerable to media sensationalisation, Mei Xinyu expressed his doubts concerning the motives behind foreign scepticism about the identity of Chinese SOE investors. He suggested that it was nothing but a convenient excuse for attacking and blocking Chinese investment, whatever the real reasons might be. According to Mei’s observation, even if the Chinese investors had no government background, Western governments would still use other excuses to limit Chinese investment. Mei argued that Australian hostility towards Chinese government investment fundamentally derived from an identity barrier, given the growing conflict between Australia’s Anglo-Saxon Western identity and its irresistible and deepening economic integration with East Asia (Mei June 8, 2009; Mei June 7, 2009).

Some Chinese scholars suggested that China’s overseas resource-related direct investment in Western developed countries often encountered investment barriers that took legislative forms and allowed the foreign investment authorities to exercise significant discretionary power to block and restrict foreign investment into certain economic sectors. They suggested national security concerns were the most common forms of political resistance against Chinese resource investment from the host governments in developed countries (Zhang, 2010: 114-120). However, some held the view that national security concerns would not have arisen in the first place if the investment had come from other Western countries instead. There was also a common perception that in some investment cases national security concerns had been used as a pretext for protectionist purposes. For instance, Zhang Guangrong noted that resource security was not the only or even the most important source of national security concern; in fact, national security concerns were used as a pretext for investment protectionism, and that there were some circles in these Western countries that still held distorted views about China under the sway of the Cold War mentality (Zhang, 2010: 115).

Some Chinese commentators even suggested anti-Chinese racism as the source of Australian discrimination against Chinese investors. He Liangliang, who was a senior commentator with Phoenix TV, aired his grievances in an article for the Hong Kong-based newspaper *Wen Hui Bao*, denouncing racial discrimination faced by Chinese investment in Australia following the collapse of the Chinalco deal (He June 10, 2009). According to He's understanding of the event, Chinalco had fallen victim to the mentality of 'White Australia' that had worked against the deal. Furious at the Australians getting so paranoid about Chinese investment, He warned that the future prospects of Australia's economic partnership with China would be marred if the Australian government succumbed to (racist anti-Chinese) public opinions and acted based on unfounded allegations of sinister Chinese intentions.

## 3.7 Chinese Adaptation to Investment Predicament

### 3.7.1 Inter-governmental and Public Diplomacy

The issue of Australian discrimination against Chinese government investors had become a major agenda in the bilateral inter-governmental dealings. The Chinese government was eager to break down Australia's regulatory barriers for Chinese investment via economic diplomacy. They had repeatedly urged the Australian government to remove the discriminatory policy measures against China's SOEs and not to make an issue of the government background/state-ownership of Chinese investment entities.[114] China's policymakers and officials would use every opportunity to press their Australian counterparts to treat Chinese investors fairly and make the approval process more transparent, efficient and fair.[115] Access for Chinese investment was also a key agenda for discussion during senior- and summit-level talks. Behind-the-scene economic diplomacy was also under way at the bilateral free trade negotiation.[116] Beijing made a great fuss about the investment entry issue and was pressing Canberra to grant greater investment access for Chinese state-owned enterprises to Australia's resources sector (Larum, 2011).

Much of the inter-governmental dealings took place behind closed doors. However, Chinese officials were also keen to defend Chinese SOE investment and dispel foreign concerns about Chinese SOE investors in the public arena. Chinese diplomats in Australia actively engaged in public diplomacy, lobbying the Australian government for Chinese investment. Since 2008, the Chinese ambassador to Australia, Zhang Junsai, had repeatedly made public pleas to Australian society to accept and welcome Chinese investment (Korporaal July 2, 2008; Xinhua April 3, 2009; Zhang April 3, 2009).

In an exclusive interview with *The Australian*, the ambassador called on the Rudd government to adopt 'an attitude of welcome' to Chinese companies investing in Australia, 'not the other way around' (Korporaal July 2, 2008). He said some Chinese companies were 'puzzled' by some of the difficulties in investing in Australia. He continued that he hoped that these were 'technical difficulties' that could be resolved by discussions between the two governments (Korporaal July 2, 2008). The ambassador

[114] Interview: 70

[115] Interview: 70

[116] Interview: 52

asserted that trade and investment should be a two-way street, and Chinese companies should be allowed to invest without discrimination.

The ambassador defended Chinese investors by claiming that Chinese SOEs would operate independently from the Chinese government. He reassured the Australians that China's resource investment in Australia did not seek to control Australia's resource, and was not politically motivated or orchestrated by the Chinese government (although he admitted that the Chinese were concerned about a potential monopoly in the international iron ore market). The ambassador also pointed out that the total stock value of Chinese investment in Australia remained rather modest, whether in terms of investment growth or compared to cumulative investments of other countries in Australia (Korporaal July 2, 2008; Xinhua April 3, 2009; Zhang April 3, 2009).

However, the reassurance provided by Chinese officials and diplomats hardly dispelled Australian suspicion of China's investment intentions. The Australians found the abrupt surge in Chinese sovereign resource investment in Australia since 2008-09 too unusual to be taken as a normal market phenomenon, and could hardly accept the claim that the Chinese government had stayed clear of this process. In the face of aggressive Chinese investment behaviour, Australia's growing wariness of Chinese penetration into the country's most critical economic sector was not unreasonable. Arguably, at the core of Australian distrust were Chinese investment intentions and the government background of Chinese investors.

### 3.7.2 Adjustments in Chinese Investment Behaviour

Chinese investors also endeavoured to change their investment strategy in order to reduce the risks of rejection by the Australian authorities. Efforts were made to take into account the Australian government's concerns over Chinese control, the mitigating factors set out by the FIRB and the lessons of failed Chinese investment attempts. Chinese ambitions were significantly set back after experiencing great disappointments and frustrations in Australia during the difficult years of 2008 and 2009 (Gao, 2013). Thereafter, Chinese investors appeared to have become more self-restrained and less ambitious. Adjustments were made with respect to the forms of cooperation, the scale of investment and the choice of investment targets. For instance, by aiming for lower shareholding, imposing voluntary caps on

Chinese ownership in greenfield joint ventures, and avoiding seeking controlling or substantial stakes in major resource producers. The FIRB Annual Report 2009-2010 revealed a significant fall in the average deal size for Chinese investment approvals (FIRB 2010). Many Chinese investors also recognised that they could achieve their primary objectives (for example, through financial returns from rising commodity prices and securing ore supply contracts) without taking a 'controlling' stake or seeking to be the dominant equity holder.[117] The Chinese government and state-owned companies actually had no option but to come to terms with Australia's tough foreign investment review regime.

Chinese investors also considered various alternative investment platforms and channels to reduce risks. Some Chinese financial investors turned to private equity (PE) funds and other collective investment vehicles (Larum, 2011). This was seen as a way to avoid negative media coverage, while still allowing their primary financial objectives to be achieved. As a way to 'denationalise' Chinese capital, other less direct investment means were also pursued, such as the use of U.S.- or Hong Kong-domiciled Chinese companies (SOE and private) as the special-purpose investment vehicles. Another channel was for a Chinese company to acquire a controlling stake in a small Australian company, which was then used as a vehicle to acquire stakes in a much larger Australian company. Perceived Australian hostility to Chinese equity ownership was also leading to more joint venture arrangements between the Chinese and Australian businesses, such as those iron ore joint ventures established by the Chinese steel mills and Australian mining companies in recent years.

### 3.7.3 Greater Role for Private Chinese Investors?

Many Chinese scholars advocated for the Chinese government to allow and encourage private Chinese investors to play a greater role in overseas resource acquisition. Having recognised the difficulties created by Chinese investors' government background, they urged greater state support for private Chinese businesses pursuing investment opportunities abroad. By de-politicising Chinese investment and de-nationalising China's overseas resource strategies, they hoped that it would reduce the

[117] Minority shareholding was financially less demanding and politically more viable for Chinese investors. Moreover, as the financial crisis subsided and Australia appeared to be weathering the crisis relatively well, Chinese investors consequently faced a tougher time acquiring majority stakes because Australian companies were in much better financial shape, in addition to the shifting 'national interest' test criteria.

nationalist sentiment against Chinese capital and reduce anxiety in the host country (Zhang, 2010: 121, 125, 202, 207; Chen & Su, 2010a, 2010b; Gong June 15, 2009). However, the nature of China's domestic politico-economic institution appeared to be rather restrictive in this regard.

Although instances of private Chinese investment in overseas resource sectors were increasing over the years, private Chinese investors remained marginal players in resource-related investment ventures abroad. Amongst the private Chinese investors that invested abroad, only a handful had undertaken foreign acquisitions; and amongst those with experience in overseas acquisitions, few had ventured into the resources sector (Zhang, 2010: 206). A notable example of successful private resource investment was the acquisition of a 90 percent stake in Savage River by Shasteel, which was then China's largest private steel producer.[118] The US$108 million transaction, which was made in September 2007, was the biggest overseas acquisition deal made by a private Chinese investor in the resources sector (Zhang, 2010: 206). Nonetheless, this was the exception rather than the rule. Overall, private Chinese businesses lacked the financial strength to compete with the state-owned companies in the overseas resource investment spree.[119]

In fact, China's resource-related industries were dominated by state-owned or state-controlled companies. Private companies lacked a supportive market and policy environment to prosper and expand. In addition, they rarely had the chance to compete on an equal basis with the well-protected state companies. Most of these private companies neither had the financial prowess nor the political connections to raise the necessarily huge capital from the banks or the government to undertake risky overseas investment ventures, such as those in the resources sector. This domestic reality dictated that in practice the majority of China's transnational resource investors had to be powerful, mega-sized state-owned companies.

Despite their increasing interest in transnational resource investment, private companies by and large received no significant support from the government in this regard. Arguably, they had never been in favour with the government insofar as transnational resource investment was concerned. Private

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[118] Interview: 32

[119] Interview: 32

businesses were discriminated against at home under the state-centred economic system.[120] Whilst Chinese SOEs had much easier access to government funding and bank credit, it was virtually impossible for private companies to obtain state sponsorship for transnational resource investment undertakings. The Chinese government was unwilling to provide financing guarantee to help indigenous private businesses obtain loans from state-owned commercial banks to carry out resource investment abroad. Strict restrictions imposed by foreign exchange authorities remained in place on the amount of loan guarantees the domestic parent company was able to provide to its overseas subsidiary; the overseas branches of the Chinese banks were also prohibited from lending loans to private Chinese companies operating abroad (Zhang, 2010: 206). Under these rather prohibitive financial circumstances, the ability of China's private companies to raise funds for resource investment abroad was extremely limited. In practice, the Chinese government on the whole remained mistrustful of private capital and was not in favour of the idea of letting private entities play a major role in transnational resource investment.

Given the above politico-economic realities, a shift towards a more enhanced role for private capital in China's overseas resource investment undertakings was likely to encounter tremendous difficulties under the current state-dominated economic system. The opinion of Mei Xinyu, a Chinese scholar with statist leanings, provides a revealing insight into the prevalence of statist thinking. Firmly against any suggestions about a diminished role of the state in overseas resource acquisition, Mei claimed that the SOEs (especially those national SOEs) were legitimately tasked with strategic missions in the functioning and development of the Chinese economy and were duly charged with acquiring overseas resources for the nation; China must adhere unswervingly to the basic institution of her state-led political economic structure and not bow to pressure from the West. Mei warned that if China yielded to foreign pressure by altering the fundamental structure of the Chinese economic institutions in accordance with foreign preferences, China would lose her economic sovereignty (Mei June 8, 2009; Mei June 7, 2009).

[120] Interview: 32

## 3.8 Conclusion

Given her large resource endowment, Australia was a major destination for China's outbound resource-related investment. The global financial crisis provided Chinese capital with a rare opportunity to prey on Australia's resource assets. Chinese SOEs were able to carry out intensive investment and acquisition projects with decisive policy and funding support from the state. To a large extent, many of the SOE investors were state agents playing an important role in China's overseas resource acquisition strategy. In particular, the country's resource acquisition mission was entrusted to a group of selected national SOEs. These national champions were instrumental in executing the state-led mission, and were at the forefront of the scramble for Australian resources. China's aggressive investment and acquisition spree was targeted at some of Australia's most valuable resource assets. This strategic investment pattern was suggestive of a mercantilist agenda on the part of the Chinese government investors. The powerful national SOEs were eyeing not only reliable long-term resource supplies but also a more structural control of Australia's major resource assets, in an attempt to build up China's own market influence in the global resource supply chain. The scale and intensity of the Chinese investment spree, together with the calculated nature of some of the most significant investment bids as exemplified by the Chinalco-Rio Tinto deal, were indicative of China's thirst for resource power.

Having said that, a more nuanced appreciation of the complexity of SOE identity and behaviour does not warrant a simplistic view of the role of the Chinese government investors in the resource scramble. Their evolving institutional links with the Chinese government, as well as the market imperatives for business expansion, internationalisation and vertical integration, all have to be taken into consideration when attempting to understand their motivations for investing in overseas resource projects. When looking at the Australian theatre, one has to recognise the degree of pluralism and fragmentation amongst the Chinese investors on the ground, which all too often could be neglected and overshadowed by the overwhelming perception of 'China Inc.' Arguably, those elements of pluralism and fragmentation could create difficulties for China's own strategic deliberations in the quest for resource assets in Australia. Nonetheless, the mercantilist drive underpinning China's state-sponsored scramble for Australian resources was hard to ignore.

Australia's anxiety about Chinese government investment led the Australian government to tighten its foreign investment regime against foreign government-related investment starting in 2008. The policy shift was in effect primarily targeted at the Chinese SOE investors, whose investments constituted the majority of Australia's foreign government-related investment. Australia's policy response was a bipartisan political reaction against Chinese penetration of Australia's vital economic sector. The implementation of the stringent national interest test and additional scrutiny for government-related investment reflected Australian distrust of the government background of Chinese investment entities and their investment intentions.

The pace of policy updates and adjustments was suggestive of a deep sense of wariness on the Australian side. In particular, the Australians were most worried that the close relationship between the Chinese SOE investors and the Chinese government might enable China to gain a distinct advantage in the bilateral resource politics at Australia's expense. If uncontrolled, the rapid expansion of Chinese presence and influence in the resources sector might fundamentally undermine Australia's existing power position and market advantage as a dominant resource supplier; since Chinese control of major Australian resource assets might jeopardise Australia's dominance over resource pricing and production, and affect Australia's ability to be an independent major resource supplier to the world.

The Australian authorities sought to control and limit the Chinese penetration of the Australian resources sector. The strict adherence to the case-by-case principle and the specific cases cited in this chapter suggested a strategic and selective approach. In other words, the Australian government was not trying to impose a complete ban on Chinese SOE investment: Australia could let Chinese government capital in but was only willing to forge a limited investment relationship with China (and on Australia's terms); and China should never expect Australia to compromise her core interests and dominant position in resource politics by giving China a free hand to take over Australia's most jealously guarded resource assets.

Australia's policy response was widely seen as discriminatory by the Chinese government and sovereign investors. Chinese investors and government officials alike expressed grave misgivings concerning Australia's policy discrimination against Chinese investment. There was deep mistrust amongst the Chinese of Australia's real attitude towards Chinese investment, despite Australian reassurance and denial of discrimination against Chinese SOEs. The Chinese acknowledged the Australians concern over the government background of SOE investors, but there remained a pervasive Chinese distrust of Australian motivations for restricting Chinese investment.

From the Chinese perspective, the Australian government's ambivalence, if not hostility, towards China's government-related investment had considerably strained bilateral relations and undermined China's resource security interest. The issue of Australian discrimination had consequently become a major Chinese policy concern and an area where China's power was tested and her vulnerability exposed. The Chinese government and investors tried in vain to persuade the Australian government to loosen restrictions on Chinese government-related investment. Chinese investors had no option but to adapt and adjust to the increasingly stringent foreign investment regime by restraining their own investment ambitions and appetites. Constrained by China's state dominated economic institution at home, there was limited scope for private Chinese investment in the business of overseas resource acquisition for the foreseeable future. As a result, China's mercantilist-driven resource investment and acquisition push into Australia was frustrated by Australia's firm political response. In short, Chinese government investment in Australia's resources sector remained vulnerable to Australian policy restrictions of the foreign government investment.

This observation is consistent with the overall argument of this thesis that China has had to cope with her vulnerability in her resource politics vis-à-vis Australia despite her growing power. Although the resource-hungry Chinese government investors had enormous financial resources to draw upon from a mercantilist-minded state apparatus, they had no option but to abide by the strict rules laid down by the Australian authorities against foreign government investment. China's apparent vulnerability in the resource investment politics was in stark contrast to the general perception of growing Chinese power that was derived from the phenomenal surge of Chinese investment in Australia's resources sector. When it comes to assessing the real power relationship between China and Australia in the specific area of resource investment, the reality of Chinese vulnerability is perhaps a more revealing indicator than the overwhelming yet to some extent misleading sense of rising Chinese purchasing power that engulfed Australia.

From a theoretical perspective, it can be said that the powerful Chinese government investors enjoyed a distinct advantage at the level of sensitivity interdependence: given the enormous financial support from the state, they seemed to have a better bargaining position vis-à-vis the Australian resource companies thirsty for capital. As the Australian resource companies could easily fall prey to the Chinese capital, Australia's resource interest was extremely sensitive to the huge impact of the aggressive investment and acquisition spree sponsored by the Chinese state. However, this situation was inherently unstable because the underlying vulnerability asymmetry was in Australia's favour. The Australian efforts to limit the inflow of Chinese state capital by changing the rules of the game, was an attempt to take advantage of the underlying patterns of vulnerability interdependence. Since the Australian authorities had the sovereign powers to impose a more stringent policy regime against foreign government investment, the Chinese investors were ultimately extremely vulnerable to the 'discriminatory' policy of the host government. This combined with the fact that China's politico-economic institution itself was very much state-dominated, also rendered China's outbound resource investment in Australia even more vulnerable to the screening regime that discriminated against government-related investment entities. In other words, the power position in terms of the patterns of asymmetrical interdependence was ultimately in favour of the Australian side in this particular issue, because Australia enjoyed a favourable power position deriving from asymmetrical vulnerability interdependence, which dominated the power deriving from asymmetrical sensitivity interdependence. The Chinese attempt to take advantage of its superior position (derived from state support) on the sensitivity dimension therefore ended in disaster. Surely an issue-specific perspective on the relative power relationship is necessary for analysing the power struggle here: China's overall power advantage vis-à-vis Australia could not be translated into a favourable outcome in the specific investment issue because the linkage process – whereby stronger states could also use their overall power advantage to dominate the outcome of specific issue areas – could not work under the condition of complex interdependence.

The political controversy over Chinese investment also displayed the limit to the extent to which the bilateral resource investment relationship could develop under a difficult geopolitical context. Given the inherent strategic tensions in the bilateral relations, it was extremely difficult to develop mutual trust in the bilateral investment relationship. In no small measure, the political hurdles faced by the Chinese investors in Australia demonstrated the constraining influence of a strained strategic relationship on the resource investment ties. Arguably, there is a close relationship between the general pattern of Chinese resource investment and the strategic dynamics in the broader bilateral relations. China's investment spree roughly began in 2007-08 when the two countries were experiencing a heyday in their bilateral relations. As the short-lived Sino-Australian entente of the post-9/11 era quickly came to an end after 2008, the political and policy environment for Chinese investment in Australia also deteriorated accordingly. The rise of the Australian political discourse against Chinese investment and the successive tightening of foreign investment regime against Chinese government investment, all corresponded to a worsening of the strategic ties between the two countries. Australia's growing fear of losing economic autonomy was closely intertwined with a deepening distrust of the strategic intention of a rising China, which had arguably very much shaped the Australian assessment of the economic and security impact of Chinese government investment. The revived strategic tensions also transformed the Chinese perception of Australia as a favourable destination for China's outbound resource investment. Chinese investment interests had already begun to wane towards the end of the 2000s. Not only did strategic tensions contribute to the regulatory barriers and undermined the Chinese perception of Australia as an accessible destination for resource investment, but the looming geopolitical uncertainty also posed a potential threat to the long-term security of the Chinese-owned resource assets in Australia. From a theoretical perspective, this constraining impact of the revived adversarial dynamics in the strategic dimension of the bilateral relations was arguably a consequence of realism. According to Keohane and Nye, the specific position of a situation on the complex interdependence-realism spectrum constitutes an independent variable. The increased strategic tensions in the bilateral relations marked a further shift towards the realist end along this continuum. If this theoretical notion has any real world relevance in this particular context, it can be said that the constraining effect of the strained strategic relationship on the resource investment ties, was a direct result of this movement on the spectrum.

Whilst the politics of resource investment is an important dimension of resource politics, the politics of resource trade constitutes another crucial aspect of the power politics over the distribution of gains from bilateral resource cooperation. In fact, there is an inherent link between these two aspects of resource power politics, not least because China's aggressive investment spree was in no small measure a direct response to the Chinese predicament in the iron ore trade with Australian mining companies. China's entrenched vulnerability in the power struggle over iron ore pricing was costly and taught the Chinese a painful lesson about the importance of gaining control of the upstream resources for the survival of downstream resource-dependent industries. In this regard, one has to look at the trade dimension of this resource partnership to fully appreciate China's thirst for market power in Australia's resources sector. The next chapter will discuss in detail this important dimension of the resource politics.

# Chapter 4 China's Struggle for Pricing Power in the 'Iron Ore War'

## 4.1 Introduction

China's gigantic demand for iron ores resulted in rising prices for imported iron ores from Australia and elsewhere. The country had become the world's largest iron ore importer and consumer during the 2000s, and also emerged as Australia's largest iron ore export destination. Inspired by the growing salience of the Chinese market in the global iron ore trade, the Chinese steel industry endeavoured to fight a 'war' against the dominant Australian mining companies over iron ore import prices, in response to the companies' attempts to raise ore prices. This chapter discusses the power politics of this transnational struggle over iron ore pricing between China's steel makers and the Australian mining companies. By analysing how the various Chinese industry actors endeavoured to shape and adapt to the evolving power dynamics behind the transnational battle over iron ore pricing power against the dominant Australian miners, Chapter 4 seeks to answer the thesis' research question by addressing one of the most significant aspects of China's resource politics with Australia.

Indeed, like the issue of Chinese resource investment in Australia, the battle for iron ore pricing power was one of the major arenas for Sino-Australian resource power politics. The struggle over iron ore pricing assumed an even more transnational character than the resource issue, in the sense that it involved direct conflicts between the Chinese steel industry and the major Australian (and Brazilian) iron ore companies, without the governments being at the front line. Perhaps because of this, the struggle over iron ore pricing was very much neglected in the academic literature on the bilateral relations. However, both countries had a huge stake in the outcome of this vital transnational struggle. To some extent, the issue of resource trade was more reflective of the fundamentals of the resource partnership than the investment issue was. This was because the trade relationship constituted the main pillar of the resource partnership, whereas resource investment ties remained relatively underdeveloped between the two countries. After all, the bulk of the bilateral resource trade was iron ore, best epitomised by China's dependence on Australia for resource supply, which was Australia's most important and lucrative exported commodity to the Chinese market. Because of the immense interests at stake for both countries, the iron ore pricing issue was arguably the focal point of the resource interdependence between China and Australia; and the battle for iron ore pricing power became the most intense battle in the bilateral power struggle over resource interests.

In fact, even China's scramble for Australian resource assets was closely related to the Chinese battle with the Australian mining giants for iron ore pricing power. As mentioned at the end of the previous chapter, there was a strong causal relationship between the battle for iron ore pricing and the struggle over Chinese resource investment in Australia. The aggressive Chinese investment spree in Australia was in no small measure a direct response to the Chinese predicament in the iron ore trade with the dominant Australian mining companies. China's entrenched vulnerability in the power struggle over iron ore pricing was costly and taught the Chinese a harsh lesson about the importance of gaining control of the upstream resources for the survival of downstream resource-dependent industries. Although the acquisition of Australia's iron ore assets was not the only target for Chinese investors, large iron ore assets were indeed among the most popular targets for Chinese investment and acquisition projects in Australia. After all, China's experience in the iron ore pricing debacle had led the Chinese to believe that increased Chinese ownership and control of upstream iron ore resources in Australia could significantly enhance Chinese market influence over iron ore pricing and increase downstream steel makers' ability to absorb the costs of surging raw material costs. This market logic was quite a transparent motivation behind many of the huge Chinese investment ventures into Australia's iron ore assets. In a sense, the Chinese experience in the transnational struggle over iron ore pricing greatly influenced Chinese geo-economic thinking about the mineral resource strategy at both the national and corporate levels. In other words, if Chinese resource investment in Australia was ultimately aimed at acquiring a dominant market influence centred on the control over resource pricing, then the iron ore pricing issue could be regarded as the 'fuse' that lit the great controversy over Chinese investment. From this perspective, the power politics over Chinese resource investment was essentially a continuation of the power politics over iron ore pricing between China and Australia. In order to fully appreciate China's geo-economic and market rationale behind her thirst for Australian resources assets, it is necessary to look deeper into the trade dimension of the bilateral resource politics; and the iron ore pricing war is the most relevant starting point in this regard.

This chapter begins with a description of the iron ore market background, followed by an account of the strenuous iron ore benchmark price negotiations since China joined the annual benchmark price negotiation in 2003. The next section illustrates the disunity within the Chinese steel industry (between the state sector and the private sector), and how this undermined Chinese negotiation efforts and power position vis-à-vis the mining companies. The fifth section discusses how the Chinese steel industry's grievances led to the politicisation of the iron ore price issue in China and state intervention on economic security grounds, albeit not a full-scale one. The sixth section explains why the growing prices of imported iron ore became an issue for the Chinese steel industry itself and the market dynamics which rendered it an intolerable burden for Chinese steelmakers. The seventh section illustrates some major Chinese efforts to reduce China's dependence on the three dominant iron ore suppliers.

This chapter aims to shed light on the market rationale for the Chinese steel industry's (especially the state-owned sector) growing sensitivity to iron ore price increase, and the process whereby the iron ore price issue became politicised in China to emerge as a national economic security agenda. It will cover three areas of discussion: the steel industry's power position vis-à-vis the Australian mining giants in the transnational struggle for pricing power; how Rio Tinto and BHP Billiton were able to dominate iron ore prices and pricing regime; and Chinese attempts to assert their own influence. These three areas of discussion ensure that the analysis is in keeping with some of the research objectives set out in Chapter 1. More specifically, the chapter contains discussions of the roles and interests of various Chinese actors involved in the politics of iron ore pricing, the basic pattern of power relationship between the Chinese and Australian actors, and the Chinese and Australian responses in the transnational power struggle.

The main argument of this chapter is consistent with the thesis' central assertion that China has to navigate between vulnerability and power in her resource politics vis-à-vis Australia. The Australian mining companies were pushing for a price rise for long-term contract ores in the annual benchmark price negotiations with the major iron ore buyers. Since joining the collective price negotiation regime, the Chinese iron ore buyers had been striving to bring down benchmark prices and fight for pricing power vis-à-vis the dominant iron ore mining companies. This chapter argues that the Chinese steel makers remained vulnerable to iron ore price hikes initiated by the Australian (and Brazilian) mining companies in the transnational struggle for pricing power. Despite becoming the world's largest iron ore importing and consuming country, China still lacked and failed to acquire market influence over iron ore price, as well as initiate a pricing regime that was commensurable with the country's overall market status in the global iron ore trading business. The Chinese ore buyers had no option but to adapt to the dominant influence of the Australian mining companies over iron ore pricing, even while the Chinese steel industry had become increasingly sensitive to the growing costs of imported iron ores.

The conflicts over iron ore pricing demonstrate that the bilateral resource partnership was far from harmonious and equitable. The outcome of the power politics revolving around the iron ore pricing issue was suggestive of the vast disparities in pricing power between the Chinese ore buyers and the Australian ore suppliers. Arguably, this unequal power relationship had in effect led to a disproportionate distribution of gains from the massive iron ore trading between the Chinese and Australians; and the continuation of such inequitable terms of trade was highly suggestive of the true nature of China's resource partnership with Australia. It might not be entirely fair to suggest that Australia had been exploiting China in the iron ore business. To some extent, this claim can even seem somewhat counter-intuitive, since it is the resource-supplying country that is usually at the receiving end in the political economy of dependency theory, not to mention the vast overall power disparities between the two countries that remain in China's favour. Nonetheless, China's vulnerable situation in the intense power struggle over iron ore pricing vis-à-vis the Australian mining companies, as well as the ensuing political manoeuvres inside China, do seem to suggest that this resource trading partnership was far from a genuinely equitable and reliable one. The analysis of the iron ore pricing war therefore also sheds light on the fundamental character of China's resource relationship with Australia.

From a theoretical perspective, the Chinese predicament in the iron ore pricing issue demonstrates the Chinese steel industry's sensitivity and vulnerability vis-à-vis the Australian mining giants in the power politics of asymmetrical interdependence. As with the investment politics, the power politics of iron ore trade also took place under the condition of complex interdependence. Hence, similar dynamics of complex interdependence as seen in the resource investment arena can also be observed in this particular arena of resource trade. Under complex interdependence, the linkage process breaks down: thanks to the diminishing role of military force and traditional (military) security agendas, stronger states are no longer free to resort to a linkage strategy to dominate the outcomes of specific issues. Since the more powerful states cannot use their overall power advantage to secure a favourable outcome on a particular issue area, the outcome of that issue is likely to be determined by the patterns of issue-specific power relationship rather than the overall power relationship between the states. As a result, the issue-structure model is a more relevant explanatory model than the overall structure model for analysing the issue-specific power politics under complex interdependence (Keohane & Nye, 2011: 42-44).

According to Keohane and Nye, asymmetrical interdependence can be a source of political power; hence, the issue-specific power relationship is very much determined by the underlying patterns of asymmetrical interdependence. Moreover, since power deriving from asymmetrical vulnerability interdependence tends to dominate over power deriving from asymmetrical sensitivity interdependence, the outcome of a specific issue under complex interdependence is most likely determined by the patterns of asymmetrical vulnerability interdependence between the two opposing sides. The policy implication of this power perspective is that states can manipulate the issue-specific asymmetrical interdependence as a policy instrument in the power politics of economic interdependence. As the patterns of asymmetrical vulnerability interdependence are more important than those of asymmetrical sensitivity interdependence, the less vulnerable states in an issue area would try to use asymmetrical vulnerability interdependence as a source of power and eventually dominate the outcome in that particular issue area (Keohane & Nye, 2011: 13-15).

These dynamics of issue-specific power politics under complex interdependence are by and large consistent with the patterns of the political struggles over the iron ore pricing issue. The outcome of asymmetrical power politics over iron ore pricing was more or less determined by the patterns of sensitivity and vulnerability asymmetrical interdependence between the Chinese steel industry and the Australian mining giants. The key to understanding the power dynamics behind the iron ore pricing struggle is therefore the issue-specific power structure analysis that focuses specifically on the patterns of sensitivity and vulnerability interdependence between the Chinese and Australian actors.

Declining earnings performance during the last few years of the 2000s rendered the Chinese steel makers increasingly sensitive to the Australian mining companies' attempts to raise the annual benchmark prices for long-term contract iron ore. However, the Chinese steel industry was not only sensitive to iron ore price rises but also extremely vulnerable to the Australian pricing initiatives to raise the benchmark prices for long-term contract ores. This was because there were no alternative available other than to accept the price increase imposed by the mining companies. In other words, the costs of making any effective adjustment to create a viable alternative would be too high under the existing market situation and policy framework. It can therefore be said that the Chinese steel industry was seriously disadvantaged in terms of both asymmetrical sensitivity interdependence and asymmetrical vulnerability interdependence vis-à-vis the dominant Australian iron ore suppliers in the battle for pricing power. More precisely, the Australian mining giants had the upper hand in the power struggle over iron ore pricing power because they were able to successfully manipulate the asymmetrical sensitivity and vulnerability interdependence to maximise their gains from the iron ore trade with China. In the face of the Australian mining companies' pricing initiatives, the Chinese steel industry had no option but to accept price increases and adapt to the new short-term index-based pricing regime that was imposed on them.

In summary, although China emerged as the biggest importer of Australian iron ores, the Chinese steel industry nonetheless succumbed to Australian dominance in each round of the traditional annual benchmark price negotiations, since the Chinese steel mills were virtually deprived of any effective influence over the price negotiation or the choice of the new pricing regime. The power-oriented analysis of the politics of asymmetrical interdependence under complex interdependence theory suggests that the Australians ultimately had the upper hand in the transnational power struggle over iron ore pricing. Under complex interdependence, China's overall power advantage vis-à-vis Australia (in both military and economic terms) could not be translated into effective bargaining power in the specific issue of iron ore pricing. As the patterns of asymmetrical vulnerability were predominantly favourable to the Australians in the iron ore pricing issue, the Chinese steel makers remained the weaker party vis-à-vis the Australian mining companies, and were essentially denied a fair share of the gains from resource trade with the Australians.

Such inequitable terms of trade were also indicative of the true nature of the resource relationship between China and Australia within a delicate geo-strategic context. Indeed, the fact that the bilateral resource trade ties were far from harmonious and equitable was consistent with the general observations about the evolving nature of China's strategic relationship with Australia. The growing realist dynamics observed in the bilateral strategic relationship marked a further shift towards the realist end on the continuum between the ideal types of realism and complex interdependence. The geo-economic implication of this movement along the spectrum for the resource trade relationship was that, given the increasingly precarious and strained strategic relationship between the two countries, the bilateral resource trade ties could hardly develop into a genuinely reliable and fair partnership. The logic of this theoretically framed argument, which has been applied in the context of resource investment politics in the previous chapter, is also relevant to understanding the relationship between the broader geopolitical setting and the politics of trade in this chapter. Since the bilateral resource trading relationship also grew out of a complex geopolitical framework, the increased geopolitical tensions in the strategic dimension of the bilateral relations must have affected the structure of the political economy of the vital resource trade between the two countries. Indeed, although the robust resource trade relationship was much more developed than the investment relationship, it was by no means a genuinely equitable and fair partnership, as Australia's dominant mineral suppliers were bent on taking advantage of the vulnerability of the Chinese steel industry to maximise short-term profit. In a sense, Chinese vulnerability in the transnational struggle for iron ore pricing power was to an extent attributable to international geopolitical constraints that stemmed from China's broader geopolitical interactions with Australia.

## 4.2 Iron Ore Market Background

The global iron ore market used to be a buyer's market in the 1980s and 1990s. Since the mid-1990s up until the 2000s, the global mining industry witnessed a series of mergers and acquisitions. Vale (alternatively known as CVRD), Rio Tinto and BHP Billiton emerged as the three largest iron ore producers and exporters, respectively, that dominated the global market (Yin & Fan & Li, 2009: 53-54). The combined total of their iron ore output in 2008 constituted about 33 percent of global output: with Vale accounting for 15 percent, Rio Tinto for 10 percent and BHP Billiton for 7 percent. In addition, the combined total of their iron ore exports in the same year made up more than 70 percent of the world's iron ore trade; with Vale contributing 33 percent, Rio Tinto 23 percent and BHP Billiton 16 percent (Liu March 2, 2011). In other words, the iron ore market was dominated by Australian, and to a lesser extent Brazilian, companies. Beginning in the early 2000s, global demand for iron ore rose dramatically, with China playing a pivotal role in the process. The consolidation of the iron ore mining industry and the rising demand for iron ore, together transformed the iron ore business from a buyer's market into a seller's market.

During the same period, the centre of gravity for the global iron ore business shifted from the European market to East Asia. This was marked by the rise of China in the global iron ore trade. During the 2000s, China became the world's largest importer and consumer of iron ore, and was also the largest import market for long-term contract iron ore and had the world's biggest iron ore spot market. China became the world's largest steel-consuming country in 2001 (Yang, 2010: 53). The country's annual steel output had already surpassed 100 million tons in 1996 to become the largest in the world (Yang, 2010: 51). During the years that followed, Chinese steel output rose annually, and the Chinese steel industry experienced a period of unprecedented rapid expansion and growth in the 2000s[121] (Dou & Tang, 2009: 153, 165). With a thriving steel industry and surging crude steel output, China became the world's biggest iron ore importing country in 2003 (Yang, 2010: 53), and a net steel exporter in 2006 for the first time in history (Yang, 2010: 51).

Despite expanding domestic iron ore production, the output and quality of indigenous ore could not meet

[121] See: http://finance.sina.com.cn/review/observe/20050723/16071828378.shtml; http://www.china.com.cn/economic/txt/2009-06/24/content_18000332_3.htm

the demand and requirements of China's fast-growing steel industry. Chinese iron ore mines were difficult to develop, containing mostly magnetite ores, which were costly to extract, and low-grade ores with very low iron content.[122] Imported iron ores had significant advantages over indigenous ores in terms of quantity (output), quality (ore grade) and cost (extraction costs). The proportion of domestically produced iron ores to total iron ore consumption fell despite increasing indigenous output over the years (Yang, 2010: 121). Meanwhile, China's overseas iron ore dependence ratio rose from 44 percent in 2002 to 69 percent in 2009 (Drysdale & Hurst, 2012). Before the global financial crisis, the ratio peaked at 58.8 percent in 2004, and remained over and above 53 percent with growing volume of iron ore imports thereafter (Yang, 2010: 120-122). Over the period between 1997 and 2008, the volume of imported iron ores surged from 55.11 million tons to 443.66 million tons (Yang, 2010: 121-122).

Australia, Brazil, India and South Africa were China's biggest iron ore suppliers. The combined volume of Australian and Brazilian iron ores flowing into China constituted about two-thirds of the total iron ore imports in 2008 (Yang, 2010: 123-124). As China's largest source of iron ore imports, Australia was of critical importance to China's iron and steel industry. From 2008 onwards, the proportion of Australian ores to the total iron ore imports (measured by weight) remained over 40 percent, and increased steadily over the years. In the period between 2003 and 2007, the proportion of Australian ores was very close to 40 percent of the total iron ore imports, and in 2005, the ratio exceeded 40 percent.[123] Out of the 686 million tons of total iron ore imports in 2011, 297 million tons were from Australia alone, which was about 43 percent of the total imports.[124] The proportion of Brazilian ores has experienced a gradual and slight decline since 2007, while the proportion of Indian ores has also been in steady decline since 2005.

The global iron ore trade has mostly been carried out through the negotiation of long-term contract arrangements; a system which has been in place since 1981 (Yang, 2010: 130). The main advantage of this arrangement has been to reduce risks for both iron ore producers and steelmakers in a volatile iron

[122] See: http://www.zgkyb.com/zhuankan/20141021_9413.htm; http://www.chinanews.com/cj/cj-gncj/news/2009/09-03/1849406.shtml; http://finance.sina.com.cn/chanjing/cyxw/20120301/140311491221.shtml

[123] Source: 'Analysis of China's Iron Ore Import Situation' (February 27, 2012) http://news.xinhuanet.com/futures/2012-02/27/c_122757992.htm

[124] Source: 'Chinese Iron Ore Imports Reached 686 Million Tons in 2011' (February 15, 2012) http://www.cnljxh.com/JCKA/2012/2/15/215G81CF.html

ore market, to reassure both sides about future demand (for producers) and supply (for buyers) within the contract period (over the agreed number of years). The price of long-term contract ore is subject to annual negotiation. The long-term contract benchmark pricing is a mechanism whereby the major three iron ore sellers (Vale, Rio and BHP) and major buyers, would gather together annually to negotiate and determine the price for the long-term contract ores for the forthcoming fiscal year. The annual benchmark pricing regime would fix the ore prices for a year and hedge against the risks of large price fluctuations for both ore suppliers and buyers during that period. The annual benchmark price negotiation would traditionally begin during the previous December and usually conclude in March or April at the latest.[125] The new annual pricing agreement would then apply from April 1 to March 31 in the following year, a period which would correspond to the Japanese financial year.[126] Each individual steelmaker and producer negotiated with each other simultaneously. Once an initial settlement was reached, the rest of the steelmakers and iron ore producers were expected to automatically accept the initial settlement, and agreed prices would subsequently be followed by all parties as the benchmark prices for long-term contract ores in that particular year (Yang, 2010: 130).

Spot market trading took place at the designated iron ore ports with *ad hoc* transactions and immediate delivery. The spot market prices were set instantaneously, much more volatile and responsive to the changing demand and supply conditions. Virtually all of the world's iron ore trade outside of China was carried out under the long-term contract arrangement. China hosts the world's only significant iron ore spot market, which is growing rapidly. The majority of China's small- and medium-sized steel mills, which numbered in the thousands and are mostly private businesses, were excluded from the long-term contract system and had to buy imported iron ores at the spot market.[127] A significant proportion of the spot market ores came from India, but the spot market had been dominated by Australian and Brazilian ores. The volume of spot market trading had been modest in the past, and for many years spot market ores were cheaper than the long-term contract ores. After market conditions reversed in the early 2000s,

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[125] See: http://finance.eastday.com/m/20061024/u1a2396869.html; http://finance.eastday.com/m/20061024/u1a2396869.html

[126] See: http://www.gov.cn/jrzg/2009-08/18/content_1394894.htm; http://news.xinhuanet.com/zgjx/2010-06/13/c_13348238_3.htm; http://finance.sina.com.cn/chanjing/cyxw/20090818/04546629027.shtml

[127] Source: 'Why Bribe' (April 5, 2010) http://magazine.caixin.com/2010-04-05/100131722.html

iron ores were in short supply and growing demand forced Chinese steel mills into the spot market. By 2008, the volume of trade in the spot market had grown to approximate the volume of long-term contract ore supplies (Leaver, 2010). During this booming period of the iron ore business, the spot market price became persistently higher than the long-term contract benchmark price.

## 4.3 Benchmark Price Negotiations

China joined the long-term contract benchmark price negotiation at the end of 2003 for the 2004-05 round. Until the 2008-09 negotiation, the Chinese team was led by Baosteel, which was China's biggest steelmaker. As a latecomer, the Chinese negotiators played only a marginal role in the first few years, but they soon became dissatisfied with their position on the periphery, particularly in the face of Japan's leading role on the buyers' side. The Chinese became increasingly disgruntled at the fact that they had to accept and follow the benchmark price set by the Japanese steelmakers with the iron ore producers, despite their position as number one position iron ore importing country (Leaver, 2010). The first 'Chinese' benchmark price appeared three years after China joined the negotiations. In December 2006, Baosteel secured the first benchmark price settlement for 2007 with Vale by agreeing to a further 9.5 percent rise in the iron ore price from the previous year.[128] This was the first time ever that the long-term contract benchmark price had been set by the Chinese, and was consequently viewed as a great success and a landmark event in pursuance of iron ore pricing power (Yang, 2010: 133; Yin & Fan & Li, 2009: 79).

Despite this success in securing the initial settlement, Chinese misgivings and anguish over successive dramatic benchmark price hikes grew considerably. Since the mid-2000s, Chinese steelmakers and government officials were disturbed not so much by Japan playing a dominant role in the talks, as by the aggressive rise in ore price over the years (Leaver, 2010). The Chinese became increasingly worried about the continued surge in the benchmark and spot market prices. A deep sense of vulnerability became pervasive amongst the Chinese elite in the face of the dominant bargaining position of the iron ore producers and the lack of bargaining power on the buyers' side. This generated a new imperative to fight for market power on long-term contract pricing in order to keep the price hikes in check. Growing demand for imported iron ore fuelled growing expectations that China, as the biggest buyer, deserved fairer (if not special) treatment by the iron ore producers, and that Chinese steelmakers should seek greater pricing power given China's growing prominence in the global iron ore business.

Chinese vulnerability in the iron ore benchmark price negotiation was felt most acutely in the final three years of the 2000s. During this period, not only did the benchmark price continue to rise exponentially

[128] Source: 'CVRD, Baosteel Agree to Benchmark Iron Ore Price Rise (Update5)' (December 21, 2006) http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aFjPvh.7fFis

beyond Chinese control, but the very mechanism determining the annual benchmark pricing also collapsed to the detriment of Chinese interests. During this process, both the Chinese side and the iron ore suppliers significantly stepped up actions to fight against the other, whether in benchmark price determination or over the reform of the benchmark pricing mechanism. China's lack of bargaining power became fully evident in the cut and thrust and arm-twisting that culminated in the final showdown with the dominant iron ore producers.

### 4.3.1 2008 Negotiation

In February 2008, the Chinese negotiators accepted and followed the Japanese benchmark agreement struck with Vale despite their initial hesitation and reluctance. The negotiations between the Chinese steelmakers and the Australian mining companies entered a deadlock and dragged out for more than half a year. The Chinese negotiators rejected outright Australian attempts to raise the benchmark price by 95 percent and refused to accept demands for CIF (cost, insurance, freight) pricing, which would supposedly give the Australian companies a free hand in taking further control of iron ore shipping and freight costs, and marking up the iron ore price. The stalemate in Sino-Australian price negotiations persisted into late June, when the expiry date of Rio's long-term contracts was only 7 days away. On June 23, the Chinese negotiators eventually yielded to Rio Tinto's demands by agreeing to a 79.88 percent increase in the price of iron ore fines and 96.5 percent increase in the price of lump ores with retrospective effect from April 1.[129] The agreement came after Rio and BHP issued an ultimatum that threatened to permanently and completely terminate the long-term contract supply arrangement unless the Chinese accepted increases in iron ore benchmark prices by 85-95 percent from the previous year.

The tense situation had almost brought the traditional long-term contract and annual benchmark pricing systems to the verge of collapse, and would have done so if the two sides had failed to reach an agreement on the new benchmark price. Not only was the extent of the price rise in the 2008 benchmark negotiation unprecedented, but the negotiation showed the first signs of a rupture in the annual benchmark pricing mechanism: the long-term contract ores from the Australian and Brazilian producers

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[129] Source: 'Baosteel Agrees with Rio Tinto on Iron Ore Price Hike' (June 24, 2008) http://www.chinadaily.com.cn/business/2008-06/24/content_6789381.htm

began to be charged differently; and the mining companies began to charge higher prices to Chinese steelmakers, i.e., a 'discriminatory' benchmark price came into effect and was targeted at China.[130] The Chinese gave up resisting at the last minute because they could not afford to allow the benchmark pricing arrangement to collapse. If the long-term contract regime and benchmark pricing mechanism were to collapse, Chinese steelmakers would have to buy the more expensive spot market ores and become more vulnerable to the price fluctuations and price rises in this volatile market.

### 4.3.2 2009 Negotiation

The onset of the global financial crisis in the second half of 2008 altered the demand and supply conditions of the global steel and iron ore markets. The slowing Chinese economy slashed demand for steel products and iron ore. The Chinese steel market experienced months of sluggish demand for steel with plunging steel prices. As demand for iron ore dropped, Chinese steelmakers stopped buying new ores from the spot market. Spot market price (in China) plummeted to an all-time low. For the first time in many years, the spot market price fell below the long-term contract benchmark price (Leaver, 2010). The market conditions now seemed to be in the ore buyers' favour; and the Chinese bargaining position vis-à-vis the iron ore producers seemed to have been significantly enhanced. The Chinese thus expected that the time had come for China to reverse her vulnerable position and to gain pricing power in the 2009 benchmark negotiation. The consensus then was that the iron ore market had entered a phase of oversupply and was moving away from being a seller's market.[131] Exhilarated by this unprecedented opportunity, the Chinese were determined to take full advantage of the new market situation to push down the benchmark price.

Unlike Baosteel, China's new lead negotiator - China Iron and Steel Association (CISA) - assumed a high profile from the very beginning. The CISA's vowed never to give in even if the price talks would breakdown. By talking tough and adopting a proactive media strategy, the CISA hoped to put pressure on the mining companies and convey the message to the domestic audience that the CISA would take a

[130] Source: 'China-Australia Iron Ore Negotiation Settles' (June 24, 2008)
http://news.xinhuanet.com/fortune/2008-06/24/content_8426539.htm

[131] Source: 'First Sign of Price Cut in Nine Years' (November 4, 2008)
http://news.xinhuanet.com/fortune/2008-11/04/content_10302693.htm

tough stance on the matter.[132] In fact, since the 2005 negotiation whereby the benchmark price was raised by 71.5 percent, the CISA had come to regard the annual benchmark price negotiation as a contest for market power and become determined to fight a battle for national honours.[133]

In reality, the Chinese assertion of pricing power had little influence over the mining companies. BHP Billiton was insisting on pushing for a new index-based pricing mechanism; Rio Tinto was keeping silent on index pricing, but was keen to increase spot market sales and rejected outright the Chinese demand for a 40 percent price cut and would only accepted a price reduction of no more than 33 percent.[134] Like BHP, Rio was not anxious to finish price negotiation; instead, it was waiting for the recovery of the steel and iron ore markets. By May 2009, Rio Tinto began to threaten that it would duly scrap the long-term supply contracts in accordance with the relevant provisions if no benchmark price agreement was reached before June 30.[135] The Chinese refused to accept and follow the initial price settlements reached by their Japanese and Korean counterparts with Rio and BHP and Vale, respectively, in late May and early June.[136] Rio Tinto warned that the Chinese could either accept the terms or withdraw from the long-term contract system.

In the face of the mining companies' refusal to offer greater price concessions for Chinese customers, the CISA stepped up pressure on the companies by embarking on a number of initiatives which were intended to enhance China's bargaining position. However, since July, China's steel mills had already begun to buy long-term contract ores from the Australian mining companies at the discounted price proposed by Rio Tinto.[137] Like their Japanese and Korean counterparts, China's steelmakers had in effect accepted the 33 percent price cut. Although the CISA insisted on calling them 'temporary prices', it

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[132]Source: 'Iron Ore Negotiations Reach Impasse: CISA's Hard-line Approach Accused of Imcompetence' (July 9, 2009) http://finance.qq.com/a/20090709/001443.htm

[133] Interview: 39

[134] Source: 'Rio Rejects 40% Price Cut and Threaten to Terminate Contract' (May 6, 2009) http://news.xinhuanet.com/fortune/2009-05/06/content_11320101.htm

[135] Source: 'Rio Rejects 40% Price Cut and Threaten to Terminate Contract' (May 6, 2009) http://news.xinhuanet.com/fortune/2009-05/06/content_11320101.htm

[136] Source: 'CISA Rejects Japanese and Korean Initial Settlements with Support from Chinese Steelmakers' (June 2, 2009) http://finance.qq.com/a/20090602/000210.htm

[137] Source: 'Chinese Steel Mills Signed Contract Discreetly with 33% Price Cut, China May Lose Battle' (July 16, 2009) http://news.163.com/09/0716/08/5EB4S9OH0001124J.html

had acquiesced to the reality, however reluctantly.[138] In retrospect, the iron ore market rebounded faster than expected. As steel production regained the momentum, demand for iron ore recover quickly and pulled up the spot market price for iron ore. The demand and supply situation in the iron ore market was once again reversed in sellers' favour. After dragging on for more than five months since passing the usual deadline in April, China's long-term contract price negotiations with the three top iron ore miners had been terminated without formal conclusion. In fact, the 2009 price talks were the last round of successful negotiations: from 2010 onwards, the annual benchmark pricing regime was completely abandoned.

### 4.3.3 2010 Negotiation

Since the beginning of the 2010 long-term contract price negotiation, the benchmark prices proposed by the mining companies had been rapidly soaring. The percentage increase demanded by the mining companies far outpaced Chinese expectations, and were beyond the bottom line set by the CISA. The Australian and Brazilian ore producers were emboldened by soaring global demand for steel as the economy recovered, and their pre-crisis assertiveness was quickly restored. From the very start of the negotiations, Vale and BHP Billiton were demanding a transition from annual pricing to a quarterly system that would be aligned more closely with prevailing spot market prices. By early April, Rio was also in negotiation with clients about long-term contract supplies based on quarterly pricing. In June, Rio indicated that it would follow Vale's prices for the third quarter supplies of long-term contract ores. Both the Australian and Brazilian miners were determined to abandon the annual pricing mechanism.[139] The three iron ore giants persisted with their tough negotiating stance until their Chinese clients gave in. Whilst turning their backs on the long-term contract negotiations, they once again manipulated iron ore supplies to pressure their clients into accepting their demand for price rises and quarterly pricing.[140]

The enunciation of the 'China model', which was set out by the Chinese in October 2009 shortly before

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[138] Source: 'Chinese Steel Mills Signed Contract Discreetly with 33% Price Cut, China May Lose Battle' (July 16, 2009) http://news.163.com/09/0716/08/5EB4S9OH0001124J.html

[139] Source: 'Rio Declares Its Support for Quarterly Pricing' (April 10, 2010) http://finance.qq.com/a/20100410/000768.htm

[140] Source: '2010 Iron Ore Negotiation in Focus' (Special Column) http://finance.qq.com/zt/2009/2010tks/

the 2010 negotiation, was deemed a tone-setting exercise. The China model had three elements: first, to bring forward the beginning of iron ore trade accounting year from April 1 to January 1 so that it would be in line with the accounting convention of the Chinese steel mills; second, benchmark prices should be linked with volumes whereby greater procurement volume should warrant greater price discount; third, all foreign iron ores must be sold at one single price in China (Jia & Liu October 17, 2009). The CISA insisted that the Chinese negotiations must be separated from the rest of the benchmark price negotiations and the Chinese would not expect others to adopt the Chinese model or price; nor would the Chinese automatically accept and follow the negotiation outcomes reached by the mining companies and others steelmakers.

This was the first time that the Chinese systematically put forward a Chinese way of price negotiation. However, the Chinese proposal was soon quietly dropped. Once the price talks were initiated in anticipation of significant price rises, it became apparent that the gaps between the Chinese negotiators and the mining companies would be hard to bridge. As the sellers firmly pressed for price increase and quarterly pricing, the CISA appeared to be completely and haplessly on the defensive.[141] The Chinese side did not entirely give in to the mining companies' pressure. Some large Chinese steelmakers had also been pleading with the Chinese government for greater policy attention and more direct government involvement in the matter.[142] The Chinese government had indeed stepped up support for the Chinese steel industry.[143] Nevertheless, the Chinese themselves had come to realise that the CISA had its limitations and was no saviour of the steel industry, and as long as the Chinese demand for steel and iron ore remained high, China's steel mills would always be vulnerable to the dominant pricing power of the big mining companies.[144]

Given the significant price cuts in 2009, the 2010 negotiation ended with 'retaliatory' price rises and a

[141] See: http://finance.qq.com/a/20100429/002290.htm; http://mnc.people.com.cn/GB/11481840.html

[142] Source: 'Heads of Steel Mills Petition for Government Intervention' (March 16, 2010) http://news.xinhuanet.com/fortune/2010-03/16/content_13180602.htm

[143] Source: 'Commerce Ministry: Needs to Preserve the Basis of Long-term Contract Arrangement' (April 16, 2010) http://finance.qq.com/a/20100416/001754.htm

[144] Source: 'CISA Concedes and Allows Individual Price Talks between Chinese Steel Mills and the Three Miners' (April 29, 2010) http://mnc.people.com.cn/GB/11481840.html

decisive victory for the mining companies over the pricing reform.[145] At the end of March, BHP reached agreements with its Asian clients on the second quarter benchmark price, with the (onshore) iron ore fines price raised by 99.7 percent. On April 1, Vale concluded its negations with most of its customers, who agreed to a 96.4 percent increase in the long-term contract price for the second quarter. Rio Tinto, which was the last to declare its intention to desert the annual pricing system, also joined Vale and BHP Billiton for the new quarterly pricing by April.[146]

In the absence of a formal Chinese price agreement, Chinese steel mills began conducting individual negotiations with each of the three mining companies beginning in April. In May, Vale suggested that it would raise the third quarter price by 23 percent for the long-term contract ores sold to China based on the surging spot market price during the second quarter.[147] In early June, Vale for the first time gave a detailed explanation of the index-based quarterly pricing methodology while confirming a further 30-35 percent price rise for the next quarter.[148] At the same time, Rio indicated its intention to follow Vale's prices and reportedly raised its price by 19.5 percent.[149] Shortly after the introduction of quarterly pricing, BHP Billiton and Rio Tinto had reportedly been pressing for an index-based monthly pricing mechanism that would track the spot market prices even more closely.[150]

China's price talks with the miners in 2010 once again ended in tatters without a formal agreement on the benchmark price and the pricing system. By the end of April, most of the big Chinese steel mills that had long-term contracts begun to arrange import of long-term contract ores from the three big mining companies under temporary price accords, based on Vale's prices accepted by the Japanese and the

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[145] Source: 'Domestic Mining Tax Expected to Fall to Increase Iron Ore Supply' (June 21, 2010) http://news.sohu.com/20100621/n272944819.shtml

[146] Source: 'Alliance between the Three Mining Giants on Quarterly Pricing' (April 12, 2010) http://finance.qq.com/a/20100412/000366.htm

[147] Source: 'Foreign Media: Vale Plan A 23% Rise for Third Quarter Price' (May 21, 2010) http://mnc.people.com.cn/GB/11658365.html

[148] Source: 'Vale Raises Price by 35%, Closing the Gap with Spot Market Price' (May 31, 2010) http://energy.people.com.cn/GB/11740873.html

[149] Source: 'Why Chinese Steel Industry Failed' (June 10, 2010) http://guancha.gmw.cn/content/2010-06/10/content_1148018.htm

[150] See: http://www.eeo.com.cn/eeo/jjgcb/2010/08/09/177523.shtml; http://mnc.people.com.cn/GB/14256642.html

Koreans.[151] The CISA also indicated at the end of the month that it had decided to give the green light to the steel mills to do so.[152] This was an indication that the Chinese steel industry had already given in to the mining companies. This despite the fact that the CISA still remained nominally opposed to the companies' price rise proposals and maintained that the temporary price accords struck by China's steelmakers with the companies were expedient arrangements only and did not represent the final formal settlements and should not be taken as evidence of Chinese surrender. By mid-2010, the steel mills were faced with multiple pricing options ranging from quarterly pricing, monthly pricing to spot market prices. The negotiation was no longer about the price itself, but the pricing method and the specific index system used to determine the price. 2010 was thus tantamount to a transition year as the pricing regime shifted from the traditional annual pricing negotiation towards short-term index pricing.

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151 Source: 'Arrival of Quarterly Pricing' (April 26, 2010) http://finance.qq.com/a/20100427/000145.htm

152 Source: 'CISA Concedes and Allows Individual Price Talks between Chinese Steel Mills and the Three Miners' (April 29, 2010) http://mnc.people.com.cn/GB/11481840.html

## 4.4 Chinese Disunity and Internal Fragmentation during Negotiations

In the face of the mining companies' refusal to offer greater price concessions to Chinese buyers, the CISA stepped up pressure on the mining companies by embarking upon a number of initiatives which were intended to enhance China's bargaining position. However, these efforts were seriously undermined by internal fragmentation and disunity on the Chinese side.

China's large steel mills had, during the previous price talks, raised their steel prices in anticipation of the increased long-term contract ore prices during the sensitive negotiation period. Such decisions were intended to hedge against the increased raw material costs, but were used by the mining companies as evidence of strong downstream demand for steel products and the steelmakers' ability to absorb higher raw material costs. In the 2009 negotiation, the CISA reportedly pressed the big domestic steel mills not to raise the price of their steel products;[153] it also requested all major steel mills to make a 20 percent cut in their steel output in an effort to create a more advantageous condition for the price talks (Yin & Fan & Li, 2009: 99). However, the CISA did not succeed in bringing the pricing policy of major Chinese steelmakers into line with CISA demands. Baosteel apparently ignored CISA's coordinating efforts by raising the July steel price in June, insisting that it was market behaviour. The CISA was therefore furious with Baosteel (Yin & Fan & Li, 2009: 99).

The CISA also organised a series of boycott campaigns against Rio Tinto and BHP Billiton during the negotiation periods. In May 2008, the CISA appealed to all Chinese steel mills and minerals import trading companies to scale down their procurement of spot market ores and to boycott Rio Tinto's (and BHP Billiton's) iron ores in the spot market as long as the Australian miners failed to fully comply with their long-term contract supply obligations.[154] In the 2009 negotiation stalemate, the CISA ordered the Chinese steel mills and ore importers not to sign new benchmark price contracts with the Australian and Brazilian ore producers before obtaining CISA's authorisation to do so. Without CISA authorisation, any

[153] Source: 'From Baosteel to CISA' (July 22, 2009)
http://finance.sina.com.cn/chanjing/sdbd/20090722/00036510882.shtml

[154] Source: 'CISA Called for Joint Effort to Boycott Spot Market Ore' (January 19, 2008)
http://news.xinhuanet.com/fortune/2008-01/19/content_7450322.htm

such agreements would be invalidated.[155] When the negotiations between the Chinese and the Australians (and Brazilians) reached a deadlock, a number of Chinese steel mills were reportedly willing to accept Rio Tinto's pricing proposals. The CISA however demanded unified actions and prohibited the Chinese steelmakers from conducting their own negotiations with the miners in private.[156] In early April 2010, shortly after the Japanese and Korean steelmakers gave in to BHP's and Vale's demand for quarterly price increases, the CISA, in conjunction with China Chamber of Commerce of Metals, Minerals and Chemicals Importers and Exporters (CCCMC) called on all qualified Chinese iron ore importers to halt iron ore imports from the three mining companies for two months so as to resist their demands for higher prices and quarter pricing.[157]

However, the CISA's leadership role proved ineffective in organising a credible industry-wide boycott. The boycotts initiated by the CISA were short-lived and lacked support at home. As Chinese iron ore stockpiles fell quickly and were about to run out, the boycott immediately lost steam because the steel mills could not afford to allow interruptions to their production. Indeed, few Chinese steelmakers had actually joined the boycott in the first place. China's many small- and medium-sized steel mills had no incentive to answer the CISA's call for boycott. These steel mills were mostly private businesses, and under China's iron ore import regime, which favoured the big and state-owned steelmakers, these smaller private steel producers had no direct access to long-term contract ore in the first place, and therefore had no direct stake in the long-term contract price negotiation. Regardless of the level of the long-term contract benchmark price, they all would have to buy ores from the spot market at the spot price. They would not benefit from the lower long-term contract price; nor would the higher benchmark price directly impinge on their business. A low benchmark price would only benefit the state-owned big steel producers that had the right to sign long-term supply contracts with the big mining companies. Hence, the private and smaller steel producers in China were not keen to support the CISA initiative at the expense of their own interests: it was more imperative to ensure stable supplies of iron ores.[158]

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[155] Source: 'CISA Warned Steelmakers Not to Sign Long-term Contract without Authorisation Or Face Losing Import Qualification' (June 11, 2009) http://news.xinhuanet.com/fortune/2009-06/11/content_11523299.htm

[156] Source: 'CISA Responds to Defection' (June 11, 2009) http://money.163.com/09/0611/03/5BGEF33000253B0H.html

[157] Source: 'CISA Calls Boycott against the Miners' (April 6, 2010) http://mnc.people.com.cn/GB/11296596.html

[158] Source: 'Demise of Long-term Contract Benchmark Price Good for Private Steel Mills' (April 6, 2010)

The CISA blamed the Chinese steel mills, particularly the small and private steelmakers, for undercutting the boycott campaign, and the leading steel producers (such as Baosteel) for ignoring the CISA advice on pricing policy during the price negotiations. However, the rules set out by the CISA were mainly voluntary and not legally binding. Moreover, the CISA was by no means fully able to represent the entire Chinese steel industry. There were more than 1,200 steel mills in China; the CISA only had more than 200 member companies, all of which were state-owned. Its core members (the biggest member companies by output and market share) were less than 80.[159] The CISA's private sector counterpart is the ACFIC (All-China Federation of Industry and Commerce) Chamber of Commerce of the Metallurgical Industry, whose members are entirely private steel producers and traders, large and small. The interests of the private and smaller steelmakers were not aligned with those of the big state-owned companies. The CISA therefore could not claim to represent the interests of these small- and medium-sized private steel mills, which collectively have a combined annual output of more than 200 million tons. It could not be expected that China's private steel mills would follow the CISA's directives and be willing to join a fight against the mining companies at the expense of their own interests for what was supposedly a state's cause[160] (Yin & Fan & Li, 2009: 114)

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http://business.sohu.com/20100406/n271324264.shtml

[159] Source: 'CISA, the Biggest Spy' (March 30, 2010) http://hi.baidu.com/crgodsaint/item/d066e60f035f0727a1312d0a

[160] See: http://finance.sina.com.cn/chanjing/cyxw/20090610/06526327518.shtml; http://www.eeo.com.cn/eeo/jjgcb/2009/07/20/144301.shtml; http://www.nbd.com.cn/articles/2009-06-12/219917.html; http://finance.qq.com/a/20090714/000561.htm; http://finance.qq.com/a/20090710/004060.htm

## 4.5 National Security Imperative for Government Intervention

Since the Chinese steel industry remained vulnerable at the transnational level, the steel industry was actively politicising the iron ore issue in China's government policy deliberation. The CISA had been pleading with the Chinese government for greater policy attention and more direct government intervention to save the industry.[161] Industry leaders advocated elevating the profile of the issue on the national policy agenda and urged the central government to give high priority to the problem.[162] For example, more than ten of China's largest steelmakers reportedly made a joint petition to the Chinese Premier in March 2010 to campaign for state intervention in the iron ore issue.[163]

Indeed, the issue of iron ore import pricing had become a strategic issue pertaining to national economic security[164] (Jiang August 8, 2009). The Chinese government had been closely involved in the iron ore war against the Australian and Brazilian miners all along[165] (Yin & Fan & Li, 2009: 61, 76, 98). Chinese authorities were reportedly preparing further measures to protect the interests of China's steel industry.[166] Though the CISA had been at the forefront of the campaign since 2009, its leadership role was bestowed by the Chinese government[167] (Yin & Fan & Li, 2009: 98).

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161 See: http://finance.sina.com.cn/roll/20090717/21436496528.shtml;
http://finance.sina.com.cn/chanjing/cyxw/20090714/13476477967.shtml;
http://www.nbd.com.cn/articles/2011-03-17/533957/print;
http://www.china.com.cn/economic/txt/2011-03/18/content_22167293.htm

162 See: http://finance.people.com.cn/GB/11480335.html;
http://jjckb.xinhuanet.com/cjxw/2010-04/29/content_219128.htm;
http://www.chinanews.com/cj/cj-cyzh/news/2010/04-28/2252071.shtml;
http://www.chinanews.com/cj/cj-gncj/news/2010/04-29/2253284.shtml

163 See: http://news.xinhuanet.com/fortune/2010-03/13/content_13162179.htm;
http://news.sohu.com/20100315/n270819960.shtml;
http://www.chinanews.com/cj/cj-cyzh/news/2010/03-16/2171646.shtml;
http://www.china.com.cn/policy/txt/2010-03/17/content_19622674.htm

164 See: http://finance.sina.com.cn/roll/20090717/21436496528.shtml; http://finance.qq.com/a/20090714/000561.htm;
http://finance.sina.com.cn/chanjing/sdbd/20090716/12246488733.shtml;
http://futures.jrj.com.cn/2008/06/000003771302.shtml; http://zqb.cyol.com/content/2009-07/21/content_2765431.htm

165 See: http://news.xinhuanet.com/fortune/2007-10/31/content_6976399.htm;
http://finance.sina.com.cn/roll/20090717/21436496528.shtml

166 See: http://jjckb.xinhuanet.com/cjxw/2010-03/17/content_212162.htm; http://www.infzm.com/content/42666

167 See: http://www.ce.cn/cysc/newmain/jdpd/yj/200908/16/t20090816_19585431.shtml;
http://stock.sohu.com/20090709/n265086581.shtml; http://www.infzm.com/content/44129

The Chinese government was assuredly following the progress of the negotiations very closely. For instance, the Ministry of Commerce expressed its support for the joint efforts of the CISA and the Chinese steelmakers in their iron ore price talks with the ore producers in a press conference in mid-March 2010. The spokesperson indicated that the Ministry of Commerce, together with the Ministry of Industry and Information Technology, would use 'necessary trade measures' to assist the Chinese negotiators.[168] The ministry spokesperson did not confirm what specific policy measures had been devised for the purpose, but nevertheless stressed that the relevant policy instruments were available and ready to hand. The official requested that the mining companies respect China's interests as the largest iron ore consumer and take into consideration the legitimate interests of the Chinese steelmakers. The Ministry of Commerce also called on all relevant stakeholders to uphold the existing annual pricing regime for the long-term supply contract.[169]

The Ministry of Industry and Information Technology (MIIT) also backed the CISA a week later. At a press briefing an official from its Raw Materials Department expressed the MIIT's support for the existing long-term contract pricing arrangement and opposition to any forms of 'monopolist' behaviour on the part of the mining companies.[170] The MIIT official reprimanded the miners for their demand for higher prices and blamed the miners for obstructing the price talks. Suggesting that the MIIT was following the negotiations closely, the official said that the MIIT supported the CISA and the Chinese steel mills in their negotiations and was highly concerned about the buyers' interests in the price talks.[171]

These instances of official posturing were arguably a last-minute attempt by the Chinese government to influence the price negotiation. The timings of such overt statements were carefully planned to influence the negotiation process as the mining companies were stepping up their push for higher prices and the traditional annual pricing regime was on the verge of being replaced. By throwing its weight behind the

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[168] See: http://finance.qq.com/a/20100316/005818.htm; http://finance.ifeng.com/news/special/tiekuangshi/industry/20100317/1939183.shtml; http://www.chinanews.com/cj/cj-cyzh/news/2010/03-17/2173568.shtml

[169] Ibid.

[170] See: http://finance.people.com.cn/GB/11206545.html; http://news.xinhuanet.com/fortune/2010-03/23/content_13230769.htm; http://news.qq.com/a/20100323/002882.htm; http://finance.sina.com.cn/roll/20100324/01227618895.shtml; http://business.sohu.com/20100327/n271133165.shtml

[171] Ibid.

ore buyers (and Chinese negotiators) in this way, the Chinese government was certainly anxious to pressure the mining companies and to prevent the worst-case scenario from emerging.

As part of the effort to influence the price negotiation, the Chinese government even launched in 2009 a 'counter-espionage' campaign to crack down on illegal leaks of Chinese commercial secrets by the staff of Chinese steel mills and alleged industrial espionage activities by the agents of the Australian mining companies.[172] The rampant leaks of vital industry data on the operation of Chinese steel mills had allegedly given the Australian companies the upper hand in the struggle over iron ore price at the negotiation table. The Chinese security services (including the Administration for the Protection of State Secrets and the State Security authorities) reportedly carried out investigations into the Rio 'espionage' case and the information leaks in the steel industry[173] (Wang July 17, 2009). The campaign against information leaks in the steel industry was arguably part of an unprecedented nation-wide campaign launched in 2009 to strengthen the protection of state secrets.[174] Rio Tinto workers Stern Hu and three other Chinese Rio employees were arrested on suspicion of espionage. Subsequently, the Rio Tinto incident not only led to heightened diplomatic tensions and acrimonious public rows between China and Australia, but also caused widespread concerns amongst the foreign business community in China (Mascitelli & Chung, 2011, 2012). Although the Chinese authorities eventually dropped the charge of spying on 'state secrets' in the case, the accused Rio workers were found guilty of commercial bribery and industrial espionage. The operation necessarily involved top-level decision-making and interdepartmental coordination within the Chinese government. The whole affair demonstrated China's heavy-handed approach in the crackdown on leaks of economic secrets, even occurring at the expense of diplomatic relations with Australia.

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[172] See: http://finance.sina.com.cn/chanjing/sdbd/20090716/12246488733.shtml; http://money.163.com/09/0721/02/5ENC8BFD002524SO.html; http://finance.sina.com.cn/roll/20090721/01032960308.shtml

[173] See: http://finance.sina.com.cn/roll/20090717/21436496528.shtml; http://finance.sina.com.cn/leadership/crz/20090723/11266519216.shtml; http://www.infzm.com/content/31509; http://finance.sina.com.cn/china/hgjj/20090804/10516568442.shtml

[174] See: http://finance.sina.com.cn/china/hgjj/20090804/10516568442.shtml; http://www.infzm.com/content/31509; http://www.baomi.org/bmyw_info.php?optionid=23&auto_id=325; http://zqb.cyol.com/content/2009-07/21/content_2765431.htm; http://ctdsb.cnhubei.com/html/ctdsb/20090717/ctdsb783632.html

The Stern Hu incident was highly political. The timing of the arrest, which came not long after Rio Tinto rejected Chinalco's investment proposal, indicated that the Chinese government was seeking revenge for Rio's decision to turn down the Chinalco investment deal,[175] which was indeed an outrageous outcome from the Chinese perspective and a bitter disappointment for the Chinese authorities; but the bigger picture really concerned the iron ore price issue (Leaver, 2010). Arguably, the Chinese move was aimed at influencing the iron ore price negotiation. It was intended to deter the mining companies from 'spying' on Chinese steel mills, or even to exert pressure on them to accept Chinese demand in the price negotiations.

Rio Tinto was perhaps not the only mining company that was conducting alleged 'espionage' activities.[176] It remained unclear as to why the Chinese government only chose to strike out at Rio Tinto. The collapse of the Rio-Chinalco could have played a part, as well as the perceived 'ultra-aggressiveness' of Rio's approach in the iron ore negotiation.[177] Nonetheless, the move not only greatly unnerved Rio but also BHP Billiton and Vale regarding the security and safety of their China businesses.[178]

The incident did not result in any substantial price concessions by the iron ore producers. However, the Chinese steel industry had been greatly shaken up by the pervasive leaks. The arrests and sentencing of a number of high-profile Chinese steel mill officials petrified the business circle of China's steel industry, which was henceforth haunted by an insistent atmosphere of secrecy.[179] Issues with respect to the iron

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[175] Interview 31

[176] See: http://money.163.com/09/0716/05/5EAO7TKS00252G50.html; http://finance.sina.com.cn/chanjing/gsnews/20090715/07226481430.shtml; http://finance.ifeng.com/topic/news/lituo/news/industry/corporate/20090715/941797.shtml; http://finance.ifeng.com/topic/news/lituo/news/industry/corporate/20090715/942062.shtml

[177] See: http://finance.sina.com.cn/chanjing/cyxw/20090714/13476477967.shtml; http://www.chinavalue.net/BookSerialise/BookShow.aspx?ArticleID=8447; http://finance.sina.com.cn/chanjing/gsnews/20090715/07226481430.shtml

[178] See: http://money.163.com/09/0716/05/5EAO7TKS00252G50.html; http://enews.xwh.cn/html/2009-07/17/content_86728.htm

[179] See: http://money.163.com/09/0721/02/5ENC8BFD002524SO.html; http://finance.sina.com.cn/roll/20090721/01032960308.shtml; http://finance.sina.com.cn/chanjing/sdbd/20090716/12246488733.shtml; http://money.163.com/09/0716/05/5EAO7TKS00252G50.html

ore price, the steel industry performance and the collective deliberations of the steel industry in the iron ore struggle could easily become a highly sensitive topic for discussion.[180] To some extent, the extensive media coverage of the incident in China also alerted the Chinese to the importance of economic security[181] (Jiang August 8, 2009). Arguably, the Rio Tinto 'espionage' case had come to be seen as one of the most shocking lessons on economic security in recent history.

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[180] Interviews: 30, 39

[181] See: http://finance.eastday.com/m/20090716/u1a4509081.html; http://www.nfcmag.com/article/2035.html; http://business.sohu.com/20090811/n265859692.shtml; http://bmj.kaiping.gov.cn/List.asp?ID=459; http://www.china.com.cn/news/txt/2009-07/24/content_18194142.htm; http://e-magazine.bjreview.com/VOL_007/06_E_b.html

# 4.6 Why Does It Matter?

## 4.6.1 Surging Raw Material Costs

The rise in the price of iron ore has significantly increased the costs of China's iron and steel industry. In the face of its continuous rise, the Chinese iron and steel industry has been hard hit over the years. For instance, it was estimated that the 71.5 percent rise in the price of imported iron ore in 2005 resulted in the Chinese steel industry paying an extra RMB¥20-30 billion to the mining companies in that year, which amounted to 40 percent of the total industry earnings in 2004 (Wan November 15, 2010). In 2008, it was variously estimated that China's steel industry would have to pay an additional US$8.4 billion (about RMB¥60 billion) or US$12.428 a year for a 65 percent price increase from the previous year's level.[182] In 2010, the Chinese steelmakers reportedly would have to pay RMB¥90 billion in extra raw material costs a year if the Chinese accepted a 96.4 percent rise in the price of imported iron ore; and the RMB¥69 billion industry-wide profit made in 2009 would be completely dwarfed by the increased costs from importing iron ores (Zhu April 26, 2010). It was also reported in 2010 that if the imported iron ore price increased by 30 percent, the total profits of the Chinese steel industry would be expected to diminish by as much as 40 percent (Bao March 18, 2010).

According to a Chinese official from the MIIT's Raw Materials Department, the imported long-term contract benchmark price had risen by 5.4 times from US$25 per ton in 2002 to US$136 per ton in 2008; China had paid an aggregate of RMB¥700 billion (or US$100 billion) in extra iron ore costs during the period between 2002 and 2008, in the face of the continual rises in the imported iron ores for six consecutive years; this aggregate extra spending on iron ores was more than the total industry earnings during the same period.[183] An official of the Jiangsu State Administration for the Protection of State Secrets also cited the same figures in a controversial article published in the aftermath of the arrest of Rio Tinto executive Stern Hu (Jiang August 8, 2009). According to his analysis, this RMB¥700 billion was more than the sum of the annual government revenue of Beijing, Shanghai, Tianjin and Chongqing put together, or twice as big as the government revenue of Jiangsu Province; the loss also amounted to a *de facto* transfer payment worth US$100 billion to the mining companies, which was also equivalent to the

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[182] See: http://jjckb.xinhuanet.com/pl/2008-03/07/content_88520.htm; http://www.sasac.gov.cn/n1180/n1271/n20515/n2697206/12403998.html; http://www.ynkcw.com/News/26652.html

[183] See: http://finance.people.com.cn/GB/9489974.html; http://news.e-works.net.cn/category6/news31818.htm

gross domestic output of Australia. The loss of RMB¥700 billion would also be tantamount to depriving every Chinese citizen of more than RMB¥500's worth of consumption (Jiang August 8, 2009). Notably, this estimated loss of RMB¥700 billion was widely cited in news reports.[184]

### 4.6.2 Growing Chinese Sensitivity to Raw Material Costs

Chinese sensitivity towards surging raw material costs had increased with falling steel industry profitability. Although the continued increase in raw material costs was significant in itself, the rapidly declining earning performance of China's steel industry since 2008 had rendered the rise in the price of iron ore even more intolerable. The impact of the iron ore price rise had become more acutely felt in the years since late 2008. The five years or so before 2008 corresponded to the first phase of the rapid expansion and growth of the Chinese economy during the 2010s.[185] In that period, domestic downstream demand for steel products was growing steadily and keeping apace with the rapid expansion across economic sectors, such as: housing, infrastructure construction, automobiles, ship building, and home appliance manufacturing, etc. Profit margins for steelmaking during that early period remained high and the steel mills were under no pressure to liquidate stocks and clear inventory.[186] The development of the overseas market and increased foreign demand further helped expand the market for steel products since 2005. As one of the largest and most direct beneficiaries of the Chinese economic expansion and growth during that period, the Chinese steel industry experienced rapid expansion as well as solid growth of earnings across the entire sector (Dou & Tang, 2009: 135, 165, 167, 189). The strong and growing demand for finished steel products from downstream economic sectors allowed Chinese steel mills to enjoy big profit margins without having to worry too much about the growing raw material costs. Hence, despite the gradual and then accelerated rise in iron ore prices during that period, China's steelmakers could still achieve huge profits and the iron ore price issue had yet to attract extensive media and policy attention before 2008.

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[184] See: http://finance.sina.com.cn/roll/20090811/00053002325.shtml;
http://finance.sina.com.cn/chanjing/cyxw/20090714/13476477967.shtml;
http://www.eeo.com.cn/eeo/jjgcb/2009/07/20/144301.shtml;
http://money.163.com/09/0724/07/5EVITLLA00253B0H.html

[185] Interview: 47

[186] Interview: 39

Rising costs of imported iron ore became much more conspicuous beginning in late 2008. Both domestic and foreign demand for steel products diminished significantly as the Chinese and global economies slowed down rapidly after the onset of the global financial and economic crises in the second half of 2008[187] (Dou & Tang, 2009: 189). China's RMB¥4 trillion stimulus package quickly brought temporary relief by propping up the Chinese economy during the crisis period and boosting steel demand. However, the days of easy profit and easy growth that the Chinese steel industry once enjoyed during the golden era before the economic downturn of 2008/2009 had gone forever. Henceforth, the annual earnings performance of the steel industry in China plunged and began to fall into what seemed to be an inevitable and long-term decline.[188] The severity and harmfulness of the iron ore price rise had been thrown into sharp relief by the crisis of the Chinese steel industry thereafter. The steady deterioration in industry earnings in the post-2008 era rendered the continued rise in raw material costs an unbearable burden. As many Chinese steel mills became loss-making,[189] the surging iron ore price was no longer merely a matter of raw material costs but had become a life-and-death struggle for Chinese steelmakers. That was arguably the reason why the long-term contract benchmark price negotiation has come under intense public scrutiny and media attention since 2008, and was sometimes even blown out of all proportion by the media. As the Chinese steel industry was increasingly brought to the verge of loss-making, the whole affair came to be viewed as a national affair on which the survival of the Chinese steel industry hinged

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[187] See: http://ycls.miit.gov.cn/n11293472/n11295125/n11299425/12164520.html; http://wms.mofcom.gov.cn/article/zt_gypck/kcpbg/200911/20091106614443.shtml; http://paper.ce.cn/jjrb/html/2009-01/21/content_49936.htm

[188] See: http://ycls.miit.gov.cn/n11293472/n11295125/n11299425/12164520.html; http://wms.mofcom.gov.cn/article/zt_gypck/kcpbg/200911/20091106614443.shtml; http://www.miit.gov.cn/n11293472/n11293832/n11293907/n11368223/13023732.html; http://www.miit.gov.cn/n11293472/n11293832/n11294132/n12858402/n12858492/13596309.html; http://www.miit.gov.cn/n11293472/n11293832/n11294132/n12858402/n12858492/14481313.html; http://www.miit.gov.cn/n11293472/n11293832/n11294132/n12858402/n12858492/15188028.html; http://www.miit.gov.cn/n11293472/n11293832/n11294132/n12858402/n12858492/15891265.html

[189] See: http://www.csteelnews.com/csteelnews/xwbd/djbd/201209/t20120906_73660.html; http://www.china.com.cn/economic/txt/2009-06/24/content_18000332_2.htm; http://news.xinhuanet.com/futures/2013-05/30/c_124785543.htm; http://www.csteelnews.com/xwzx/djbd/201407/t20140722_250138.html; http://www.custeel.com/shouye/common/viewArticle.jsp?articleID=3686512&group=&cat=1011001; http://finance.people.com.cn/n/2014/0217/c1004-24373870.html; http://news.xinhuanet.com/fortune/2013-08/06/c_125121937.htm

and China's economic power was being tested.

After the global financial and economic crises, the gross profit margin of Chinese steel producers declined steadily according CISA data. The annual gross profit margin reportedly fell from 7.5 percent in 2007 to the level of 5 percent in 2008, and came down to 2.8 percent in 2009 and 2.91 percent in 2010 respectively;[190] the number reportedly fell further from 2.42 percent in 2011 to 0.04 percent in 2012.[191] China's steel industry was hard hit by falling demand and plunging steel prices during the crisis and a significant number of Chinese steel mills incurred losses. Despite the fact that the steel market bounced back under the effect of the stimulus package, the annual gross profit margin for the steel industry in 2009 was as low as 2.43 percent according to some news reports.[192] This was reportedly less than half of the 5.47 percent average national industrial gross profit margin.[193] The sector's annual gross profit margin in 2010 (2.91 percent) was also reportedly far below the 6 percent average national industrial gross profit margin in that year.[194] Some news reports even suggested that the steel industry had the lowest annual gross profit margin among all the Chinese industrial sectors in 2010 and 2011.[195] The entire Chinese steel industry was said to be operating on an extremely thin and diminishing profit margin amidst adverse downstream market conditions and high raw material costs since the end of the 2000s. The steel mills no longer had the luxury of being able to transfer the burden of growing raw materials costs to downstream steel buyers.

The steel industry's situation was so severe that a significant number of steel mills, including the large

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[190] See: http://www.chinadaily.com.cn/dfpd/sd/2012-05/08/content_15238081.htm; http://fw.xinhua08.com/a/20110530/570648.shtml; http://business.sohu.com/20100318/n270908647.shtml

[191] See: http://money.163.com/13/1223/10/9GPA4MVG00253B0H.html; http://news.xinhuanet.com/fortune/2012-05/21/c_111996599.htm; http://news.sohu.com/20130329/n370938635.shtml; http://scitech.people.com.cn/n/2014/0304/c1057-24517047.html; http://finance.chinanews.com/cj/2012/02-20/3680153.shtml

[192] See: http://finance.qq.com/a/20100210/001929.htm; http://finance.qq.com/a/20100210/000632.htm; http://finance.chinanews.com/cj/2012/02-20/3680153.shtml

[193] See: http://finance.qq.com/a/20100224/002024.htm; http://finance.qq.com/a/20100210/000632.htm

[194] See: http://www.miit.gov.cn/n11293472/n11293832/n11294132/n12858402/n12858492/13596309.html; http://fw.xinhua08.com/a/20110530/570648.shtml; http://finance.chinanews.com/cj/2012/02-20/3680153.shtml

[195] See: http://news.xinhuanet.com/fortune/2012-05/21/c_111996599.htm; http://money.163.com/11/0418/15/71UBF98000253B0H.html#from=relevant; http://money.163.com/11/0416/16/71PC5KR800253B0H.html#from=relevant

ones, had been forced to diversify into non-core business activities unrelated to steelmaking as a contingency measure in anticipation of the continued stagnation, if not further deterioration, of the steel market.[196] This astonishing fact seemed to suggest that the world's largest steel industry had reached a crossroads. Given the industry's growing sensitivity to the impact of rising ore prices, the political salience of the iron ore price issue also considerably increased in the post-crisis years. If rising ore costs had not substantially impinged on the steelmakers' incomes prior to the crisis, they had begun to seriously threaten the survival of China's steel industry toward the end of the 2000s. Thus, to a large extent, the issue had become a matter of national economic security.

### 4.6.3 China's Iron Ore Complex: Chinese Misgivings and Perception of Unfairness

After years of frustration and 'defeats' in the battle for pricing power, the Chinese developed a unique 'iron ore complex': the whole business of iron ore trade was said to be unfair as the Chinese were disadvantaged and bullied into paying hundreds of billions of extra costs by the dominant mining companies. The world possesses vast reserves of iron ore and the market used to be dominated by buyers. The Chinese thus had huge misgivings about paying such a high price for such an abundant mineral. They believed that the high price of imported iron ore was not so much a result of normal demand and supply conditions as a consequence of an unbalanced market structure whereby the three dominant iron ore producers collectively monopolised the world's iron ore supply. Such a market structure and pricing mechanism were unjust because they gave disproportionate market power to the dominant ore producers; this allowed the mining companies to prey on the ore buyers and maximise their interests at the expense of the ore buyers. In addition, Chinese steelmakers were almost blackmailed into agreeing to the mining companies' demands for aggressive price increases. In short, the iron ore market was so distorted that it failed to protect the legitimate interests of the ore buyers. Indeed, the Chinese could hardly resign themselves and embrace their vulnerability in their struggle with the mining companies. As the largest iron ore buyer in the rapidly growing iron ore trade, China's steel industry

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[196] See: http://finance.people.com.cn/n/2013/0923/c1004-22996088.html;
http://www.time-weekly.com/html/20140403/24395_1.html;
http://finance.sina.com.cn/chanjing/cyxw/20130914/000816760655.shtml;
http://finance.qq.com/a/20120711/000481.htm; http://finance.chinanews.com/ny/2013/09-03/5236833.shtml

ended up being the biggest loser in the battle over benchmark price. The Chinese felt that they deserved a more equitable market mechanism that gave due respect to the interests of the downstream Chinese iron ore buyers and gave them a reasonable amount of market power vis-à-vis the upstream ore producers, under a fairer pricing arrangement.

From the Chinese point of view, the three iron ore miners had benefited immensely from trade with China, but they had shown little sympathy for the interests and concerns of their Chinese partners. In this regard, the Chinese were most annoyed with the Australians for their ungratefulness and selfishness.[197] They were most resentful of the Australians' demands for massive price rises and their leading role in abolishing the traditional pricing mechanism. Since the Australian economy was a large beneficiary of the Chinese market, the Chinese therefore expected the Australians to be more grateful and more receptive to Chinese concerns than the Brazilians were. Contrary to expectations, Rio Tinto and BHP Billiton showed no mercy to the Chinese buyers, and in fact were even more aggressive in pushing for short-term benchmark pricing and coercing the Chinese buyers into accepting price hikes.[198] The Australians seemed to have completely ignored repeated Chinese calls for a more equitable partnership, which according to the Chinese should be the essential precondition for sustainable business ties with China in the long run. Many Chinese were of the view that the Australians would have to one day pay the price for showing scant regard for Chinese interests, and taking advantage of China's growing dependence on overseas resources in the current climate, once China was able to overcome her vulnerability and get through with the resource-intensive development phase[199] (Yin & Fan & Li, 2009: 74-75).

Arguably, the Chinese felt rather isolated in this battle. The three big mining companies effectively formed a *de facto* quasi-alliance to raise prices and imposed the new short-term pricing regime on the buyers; their tacit coordination amounted to something of an undeclared collusion. By contrast, the buyers were disunited, as the Europeans, the Japanese, the Koreans and Chinese steelmakers had been fighting

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[197] Interview: 7

[198] See: http://www.chinavalue.net/BookSerialise/BookShow.aspx?ArticleID=8447; http://finance.sina.com.cn/chanjing/gsnews/20090715/07226481430.shtml; http://finance.sina.com.cn/chanjing/cyxw/20090714/13476477967.shtml

[199] Interviews: 7, 8

their own individual battles against the mining companies. China's cause received little support from their Japanese and Korean counterparts. In fact, the competitive dynamics amongst the buyers predominated and worked in the sellers' favour. The Chinese even believed that the Japanese had attempted to undermine Chinese negotiation efforts by colluding with the mining companies in negotiating a high initial benchmark price at an early stage of the negotiation so as to hurry the Chinese into following their initial settlement[200] (Yin & Fan & Li, 2009: 67-69). According to the Chinese understanding of the situation, the Japanese had a large stake in the upstream mining businesses and would benefit from iron ore price rises in any event.[201] Indeed, China was the largest ore importing country but also the only country whose steel industry was so severely disadvantaged in such a fundamental manner. Few countries in the world had such a rapidly expanding steelmaking industry as China had; few economies were in a comparable stage of development and had a similar mode of economic growth that resembled the Chinese economy. Given China's uniquely high demand for imported iron ores, the Chinese found no international allies that shared their plight. The Chinese were proud to have become the world's largest steel producer and ore buyer, but found themselves to have come to occupy a lonely position in the world.

The Chinese were increasingly upset concerning their position in the global steel business. China had been importing iron ores at high prices whilst exporting steel products at low prices. The Chinese had grown increasingly disturbed by this pattern of trade, which were severely criticised at home amidst the rising iron ore prices over recent years (Xiong & Ji June 13, 2012). This was because this pattern of trade was tantamount to subsidising foreign downstream steel users with the profits of China's steel industry. During the five-year period between 2007 and 2011, the increase in the average price of imported iron ore far outpaced the rise in the average price of China's steel exports; and the same period witnessed simultaneous growth in both iron ore imports and steel exports (Xiong & Ji June 13, 2012). Like many

[200] See: http://info.finance.hc360.com/2008/02/190807100045.shtml; http://finance.people.com.cn/GB/71364/9151786.html; http://news.163.com/09/0528/08/5ACU73MO000120GR.html; http://finance.sina.com.cn/g/20050319/14191443918.shtml

[201] See: http://news.cctv.com/world/20090724/105343.shtml; http://www.people.com.cn/GB/paper81/16192/1430559.html; http://finance.people.com.cn/GB/72020/74689/81779/5617287.html; http://www.modernweekly.com/business/content.aspx?artID=33361

export products made in China, Chinese steel exports were mainly low-value added products with very thin profit margins. Given the high raw material costs, China would be seriously disadvantaged in the global production chains for being such a large steel exporting country. Many Chinese called for a scale-down of the country's steel export sector and opposed the export tax rebates for steel products. Many industry experts held the view that China's large steel export capacity was developing to the detriment of the Chinese steel industry; and that it would be a shame to allow this unfair distribution of benefits to continue any longer (Xiong & Ji June 13, 2012).

The distribution of interest was even more unbalanced between the Chinese steel industry and the upstream iron ore suppliers. As the Chinese steel industry suffered in a deteriorating market environment, the iron ore producers were enjoying huge profit and riding the crest of the growing ore prices. China had become the largest customer of BHP Billiton, Rio Tinto and Vale. The top mining companies' sale revenues in China had kept pace with growing Chinese demand and rising ore prices over the years. The Chinese market reportedly more than one-third of their sales revenues. Even excluding Rio Tinto's 2008 revenue in China, their combined sales revenue in the Chinese market during the four years between 2008 and 2011 had reportedly reached US$153.024 billion; BHP Billiton had the biggest share, with an aggregate Chinese sales revenue of US$55.04 billion during the four years (Xiong & Ji June 13, 2012). All of the three major iron ore mining companies had been expanding their iron ore production capacities in anticipation of continued growth in Chinese demand in the years ahead. At the same time, the growing income gap between the Chinese steelmakers and the major iron ore producers also reached an alarming level. The mining companies' impressive earning performance over the years stood in sharp contrast with the widespread and deepening financial woes of China's steelmakers since 2009.[202] Whilst the upstream ore producers were able to retain the bulk of the earnings from the global value chain for steelmaking and make huge and growing profits, China's steelmakers were struggling to survive as the entire industry was brought to the verge of collapse.[203] From this perspective, the Chinese steel mills

[202] See: http://yicai.com/news/2011/02/693395.html;
http://newspaper.jfdaily.com/xwwb/html/2012-03/01/content_758517.htm;
http://intl.ce.cn/zgysj/201103/08/t20110308_22279259.shtml;
http://finance.sina.com.cn/chanjing/cyxw/20120613/132512302629.shtml;
http://business.sohu.com/20100318/n270908647.shtml

[203] See: http://www.eeo.com.cn/eeo/jjgcb/2010/06/07/171852.shtml;

were thought to have been working for the upstream mining companies and being exploited ruthlessly by these dominant ore producers.[204]

Despite the supply and demand dynamics that were in place in the iron ore market, the distribution of market power was so uneven that the Chinese steel mills virtually had to live at the mercy of the upstream miners. Liu Yongchang, former Director of the Iron and Steel Department of the dismantled Ministry of Metallurgy, compared China's iron ore trade to a blood sucking tube that was injected into the Chinese economy to suck all the profits out of China's steel businesses. Liu made the comparison in a MIIT round-table meeting held in June 2010 in the presence of MIIT Minister Li Yizhong. Denouncing the iron ore mining companies and the Western banks, Liu warned that the iron ore trade was draining the income of the Chinese steel industry and 12 related downstream economic sectors; and that the quarterly pricing system would further enhance the mining companies' ability to maximise their income from their iron ore sales to China at the expense of the Chinese buyers (Zhang & Wan June 8, 2010).

According to Liu's theory, if the Chinese steel market recovered with improving profit margins, the new pricing mechanism would enable the three mining companies to raise the benchmark price more easily and quickly. In the event of falling steel demand and declining profitability on the part of the steelmakers, the companies would raise the benchmark price to a lesser extent (or even lower the benchmark price); but they would always feed the downstream steelmakers with minimum earnings so as to ensure that the margin of the price rise would not kill the goose that lays the golden eggs (Zhang & Wan June 8, 2010). The faster and bigger the Chinese steel sector would grow, the more income the mining companies would drain and suck out through the iron ore trade.

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http://intl.ce.cn/zgysj/201103/08/t20110308_22279259.shtml;
http://www.miit.gov.cn/n11293472/n11293832/n11294132/n12858402/n12858492/13989163.html;
http://www.china.com.cn/economic/txt/2010-03/04/content_19521817.htm;
http://finance.sina.com.cn/chanjing/cyxw/20120613/132512302629.shtml

[204] See: http://www.dfdaily.com/html/113/2011/2/26/572838.shtml; http://finance.people.com.cn/GB/11077370.html;
http://www.cnstock.com/paper_new/html/2010-03/05/content_1069.htm;
http://finance.people.com.cn/GB/11746503.html;
http://newspaper.jfdaily.com/xwwb/html/2012-03/01/content_758517.htm;
http://finance.sina.com.cn/chanjing/cyxw/20120613/132512302629.shtml;
http://cpc.people.com.cn/n/2013/0701/c83083-22026713.html;
http://finance.sina.com.cn/money/future/fmnews/20140109/020517888855.shtml

The enlarging profitability and income gaps between China's steelmakers and the upstream miners (especially the Australian ones) led to continued Chinese frustration. The Chinese were therefore compelled to manoeuvre themselves out of this perceived unfair situation. However, China's attempt to rid itself of its disadvantaged and weak market status vis-à-vis the dominant iron ore miners had so far been a dismal failure. The seemingly distant and gloomy prospects of success fuelled China's angst over the country's vulnerable position since the late 2000s.

## 4.7 Reducing Chinese Dependence on Major Iron Ore Suppliers

China's over-dependence on major Australian and Brazilian iron ore suppliers proved too costly for the Chinese steel industry. The rising costs of imported iron ores over the years provided strong impetus to reduce Chinese dependence on the three iron ore mining giants for ore supplies. Indeed, Chinese news reports frequently appeared before and during the annual price negotiations, making claims about: weakening demand for iron ore; discovery of big iron ore deposits at home and increased Chinese iron ore reserves; potential increase in domestic iron ore supplies; acquisition of new overseas iron ore assets; and further diversification of the sources of iron ore imports[205] (Yin & Fan & Li, 2009: 76, 81-83). Presumably this was part of the state propaganda efforts to rally support for the steelmakers by fostering an atmosphere that would help enhance the Chinese bargaining position vis-à-vis the mining companies for the price talks. However, it remained to be seen whether in the long run such measures would significantly transform market demand and supply situations, and substantially enhance China's bargaining power.

Given China's alarmingly high overseas iron ore dependence ratio, one obvious option was to expand domestic iron ore production. The government increased policy and financial support for iron ore exploration and prospecting. Iron ores had come to be included in the category of minerals whose exploration and prospecting was given high priority. The government not only increased public investment in domestic iron ore projects but also encouraged commercial development of iron ore resources funded by non-government funds from the private and banking sectors. Total Chinese investment in iron ore exploration had been increasing since 2000 (Wu & Liang, 2010). The Chinese also speeded up the exploration and mine development projects, with investment in iron ore mining capacity increasing year on year. Once put into operation, the newly built iron ore production capabilities would enhance domestic ore supplies (Wu & Liang, 2010). Between 2003 and 2007, there had been

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[205] See: http://www.chinaweekly.cn/bencandy.php?fid=63&aid=4310&page=4; http://news.sohu.com/20091230/n269293820.shtml; http://money.163.com/11/0901/23/7CTF26J000253B0H.html; http://www.csteelnews.com/xwzx/xydt/201307/t20130719_110541.html; http://paper.people.com.cn/gjjrb/html/2010-10/15/content_645093.htm; http://news.sohu.com/20100621/n272944819.shtml; http://www.qzprice.gov.cn/News2/2010/5yue/053101.htm; http://news.sina.com.cn/o/2006-06-12/06069179265s.shtml; http://mnc.people.com.cn/GB/11810166.html

significantly increased commercial exploitation and development of domestic low grade (magnetite) iron ore reserves, which were abundant in China, and output from these low-grade iron ore deposits has risen accordingly (Wu & Liang, 2010). Moreover, China's steel producers were also seeking to acquire and manage their own iron ore assets, which would provide them with reliable and cheap iron ore supplies. Investment by steel mills in domestic iron ore projects has thus been growing fast in recent years. China's domestic iron ore output grew rapidly as a large number of iron ore projects went into operation. National indigenous iron ore production capacity reached 900 million tons per year by the end of 2009, while domestic iron ore output had risen from 261.46 million tons in 2003 to 824.01 million tons in 2008, with an average annual growth rate of 25.8 percent. The 2009 domestic output was affected by the financial crisis but still reached 880 million tons with a 6.8 percent rise year-on-year (Wu & Liang, 2010)

However, despite the growing supply of indigenous iron ore, China's dependence on imported iron ores was hard to divest itself of. Given their low-grade class and high prices, domestic iron ores were much less competitive than the imported ores, with higher grades and lower prices. Because of the low iron content and the fact that the majority of domestic iron ore deposits were magnetite ores (Yang, 2010: 114-115, 121), the mining and processing costs for the production of domestic ores were significantly higher than the production costs of foreign iron ore producers[206] (Yin & Fan & Li, 2009: 49). Rather than competing with foreign miners in the Chinese market, the survival of Chinese iron ore producers had been seriously threatened by the massive influx of overseas iron ores, especially in more recent years when both steel and iron ore demand stalled. Many of the domestic iron ore mining companies had been on the verge of bankruptcy. Adding to the woes of the Chinese iron ore companies was the heavy tax burden. The high resource tax and production value-added tax imposed on the industry raised the prices of the indigenous ores, ate significantly into profit margins and discouraged domestic iron ore production and investment. There were growing calls from the mining and steel industries to implement tax cuts for iron ore producers. The CISA, the Metallurgical Mines' Association of China (MMAC) and China Mining Association (CMA) all called for a reduction in the tax burden on domestic iron ore producers (Deng June 4, 2009).

[206] See: http://www.chinanews.com/cj/cj-gncj/news/2009/09-03/1849406.shtml; http://www.zgkyb.com/zhuankan/20141021_9413.htm

In order to diversify the sources of iron ore import, China's steelmakers and mineral traders began buying ores from other mining companies in Australia, Brazil, and other iron ore producing countries and regions in Africa, South America, Central Asia, and Southeast Asia. The number of countries that were selling iron ores to China increased markedly. For instance, by early 2010, there were more than 40 countries supplying China with iron ores; by 2011, the number had risen to 63 (Zhu December 8, 2011). Although the dominant market shares of Rio Tinto, BHP Billiton and Vale were unlikely be challenged in any fundamental way in the short-term, the Chinese were keen to trade with emerging iron ore producers if that would help them grow. After all, the world's iron ore reserves remain abundant and ore deposits are scattered around the globe. In the long-term, the Chinese would welcome the emergence of competitors around the globe to dilute the market power of Rio Tinto, BHP Billiton and Vale.

The Chinese were alert to the developments that would lead to further concentration of market power by the existing dominant mining companies. When BHP Billiton proposed a takeover bid in 2007 to acquire Rio Tinto, the Chinese were immediately galvanised into action to forestall the potential merger between the two mining giants, which if it succeeded, would further consolidate Australian miners' dominant market position and give them enhanced monopoly control of supply and prices of mineral commodities, including iron ores. The Chinese government even threatened to resort to anti-trust measures against the Australian companies. The CISA in 2008 also extensively lobbied the Ministry of Commerce against the proposed BHP-Rio deal on antitrust grounds (Xu August 2, 2008). BHP submitted an application to China's Ministry of Commerce for antitrust review purposes when China's first comprehensive competition law ('Anti-monopoly Law) took effect in August 2008, which arguably applied in the proposed BHP-Rio merger deal. According to a top official of the Ministry of Commerce, the Chinese anti-monopoly authorities were due to begin their review of BHP's takeover bid for Rio on the very day BHP scrapped its bid.[207] Chinalco's initial acquisition of a 12 percent stake in Rio Tinto PLC in early 2008 (in partnership with Alcoa) arguably had significantly complicated BHP's takeover efforts, although BHP's eventual decision to drop its hostile takeover bid at the end of 2008 also had much to do with the deteriorating market environment during the economic crisis and Rio's repeated rejections of the deal. However, after Rio Tinto turned down Chinalco's second US$19.5 billion investment proposal in mid-2009, Rio and BHP

[207] Source: 'Rio-BHP Awaits Anti-trust Review' (August 6, 2008) http://policy.mofcom.gov.cn/section/wto!fetch.action?lanmu=dt&id=CXW0005635

went ahead with the merger of their respective iron ore mining operations in the Pilbara region but with separate sales and marketing to address competition concerns (Cao May 17, 2010). The Chinese seemed powerless to intervene from a legal perspective.[208]

The steel mills extreme vulnerability in the struggle against the companies over iron ore pricing taught the Chinese a harsh lesson on the critical importance of acquiring influence over the upstream mining industry. The experience of the Japanese steelmakers also served as a reminder of the necessity of establishing control of certain key commodities and how that could be achieved through extensive vertical (industry) integration. As a result, to invest in and acquire overseas iron ore assets became a pressing priority and the most effective way for reducing Chinese dependence on the three dominant mining giants. Australia became the top destination for overseas investment for this purpose; the scramble for iron ore assets in Australia was one of the major drivers of China's massive resource-related investment in the country. China's outbound iron ore investments also went to other iron ore-rich countries and regions especially in Africa, South America and Central Asia (Rong & Ye February 23, 2009). The majority of Chinese investors were state-owned enterprises, many of them were big Chinese steel mills striving to gain their own iron ore resources abroad and reduce dependence on Rio Tinto, BHP Billiton and Vale for ore supplies.

As discussed in previous chapters, direct investment in upstream raw material production companies, whether through greenfield investment or via the acquisition of interests in the target companies, would in theory deliver a number of advantages and benefits. The downstream steel companies would be less sensitive to rising iron ore prices because losses incurred from the increased cost of iron ore would be offset by capital gains and dividends from shareholding in the raw material suppliers. Through forging strategic partnership with target companies, Chinese investors could also seek some form of power in decision-making over the sales, output and even pricing (albeit less likely) of the iron ores produced by the target companies or the joint ventures. Very often the Chinese investors would be guaranteed stable and adequate supplies of iron ore produced from the target companies or the joint ventures, depending on the specific conditions worked out by the Chinese and the foreign partners.

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[208] Source: 'Rio-BHP Merger in Danger as Rio Changing Mind' (April 15, 2010) http://finance.people.com.cn/GB/11372044.html

The Chinese government also undertook a series of policy adjustments to facilitate investment in overseas resources sectors including the iron ore mining business. State-sponsored loans were given to help finance the capital-intensive iron ore investment projects and acquisitions. The goal was to increase the proportion of imported iron ores from China's overseas captive mines to 50 percent of China's total iron ore imports.[209]

However, aggressive investment in offshore iron ore assets had yet to significantly enhance Chinese steel industry's ability to control raw material costs. Overseas iron ore mining projects were costly to develop, and delays and cost overruns were common problems facing some of the large greenfield investment projects in countries such as Australia. More importantly, acquisition of stakes in overseas mining assets or investment in joint ventures might not guarantee Chinese investors control over pricing policy or other key decision-making power. As the Australian case shows, Chinese investment was often subject to strict limitations imposed by the foreign investment authorities of the host country. Whilst pricing power was the greatest prize of all, it was also the most sensitive and hard to achieve. Iron ore supplies from captive mines were modest compared to the total volume of Chinese iron ore imports. Given the long period of development of overseas iron ore projects, outbound investment strategy could not fundamentally alter demand and supply conditions in China's favour in the short-term. The three dominant iron ore suppliers would most likely continue to dominate the global iron ore supply and prices.

Nevertheless, the consensus in China was that the development of domestic iron ore resources and acquisition of overseas captive mines were the two most important components of China's supply-side iron ore strategy. A key goal in the 12th Five-Year Plan (2011-2015) for the iron and steel industry was to increase the proportion of domestic iron ore supplies to 45 percent by 2015 (Yang November 7, 2011). According to the CISA, China also harboured the ambition to raise the proportion of iron ore supplies from China's overseas resource assets to 50 percent (up from the current 15 percent level) with the planned expansion of overseas investment.[210]

[209] Interview: 39

[210] Source: 'CISA: Output of Overseas Captive Mines Double by 2015' (December 8, 2012) http://finance.sina.com.cn/chanjing/cyxw/20121208/141413941876.shtml

## 4.8 Conclusion

Despite being the largest purchaser of iron ore, China's steel industry was repeatedly defeated by the major iron ore mining companies in the successive benchmark price negotiations. In the face of the mining companies' dominant pricing power, China's steelmakers failed to exert any effective influence over the iron ore prices and pricing mechanism. Rising iron ore costs depressed the profit margins of the steelmakers; the deterioration in the Chinese steel industry's earning performance since the global financial crisis rendered the surging raw material costs increasingly intolerable towards the end of the 2000s.

Given the Chinese steel industry's vulnerability and sensitivity to iron ore price hikes, the issue of the price of imported iron ore emerged as an important national agenda at the instigation of the Chinese steel industry. The state-owned enterprises, which were the biggest Chinese stakeholder, endeavoured to politicise the industry's predicament over the affair and lobby the Chinese government to intervene in its transnational struggle with the global mining giants. This conflict consequently came to be seen as a matter of national (economic) security by the Chinese authorities, as demonstrated by the Chinese manoeuvres in the controversial 'Rio Tinto espionage' incident.

China's increasing adversarial stance was mostly targeted at Australia. This was partly because the two Australian companies were the most aggressive and domineering amongst the three major ore suppliers during the price negotiations. To Chinese eyes, the Australians also led the way in bringing down the traditional pricing mechanism and imposing an even more 'exploitative' pricing system on the iron ore buyers.

The Chinese had grave misgivings about the Australian companies' ruthless pursuit of profit maximisation at Chinese expense. Grievance against the Australian companies was understandable because China apparently paid an exorbitant price for Australia's ore supplies. Rio Tinto and BHP Billiton had been using their leverage to ruthlessly prey upon the downstream Chinese steelmakers with scant regard for their development and survival. Their dominant power position deriving from favourable patterns of asymmetrical vulnerability interdependence enabled them to deny the Chinese steel industry reasonable profits and equitable terms of trade in the iron ore trading business.

In light of the immense benefits gained by the Australians from their lucrative iron ore business, the Chinese perceived the iron ore trading relationship as the most unfair and exploitative aspect of the bilateral resource ties with Australia. Since the iron ore business constituted the bulk of China-Australia resource trade, which in turn was the main pillar of the bilateral resource partnership, the pattern of distribution of the gains from the trade was to some extent indicative of the true nature of China's resource relationship with Australia. From the Chinese perspective, this ongoing pattern of resource cooperation was inequitable, exploitative, bullying, and therefore unsustainable.

The empirical findings of this chapter reinforce the overall argument of the thesis that China has to cope with her vulnerability despite her rising power, in her resource power politics vis-à-vis Australia. The Chinese steel industry's growing sensitivity to iron ore price increases indicates an awareness of the unfavourable patterns of asymmetrical sensitivity by the Chinese. More importantly, the repeated failure of the Chinese to secure lower ore prices at the negotiation table and their reluctant acceptance of the new pricing regime imposed by the dominant Australian mining companies, suggest the underlying patterns of asymmetrical vulnerability interdependence were also disadvantageous for the Chinese actors in the struggle. As a result, the Chinese steel makers remained completely vulnerable to Australian pricing initiatives to raise the ore price. Despite the fact that China had emerged as the world's largest iron ore importing country and the biggest export market for Australian iron ores, the Chinese failed to translate the country's overall market strength into real market power over commodity pricing in the iron ore pricing war, and were forced to adapt to the Australian dominance over the iron ore trade. This, in tandem with surging raw material costs and a deteriorating Chinese economic environment, almost brought the entire Chinese steel industry to its knees.

Arguably, China enjoyed an advantageous overall power position vis-à-vis Australia; but under complex interdependence, the outcome of a specific policy issue area is very much determined by the issue-specific power structure in terms of the patterns of asymmetrical interdependence. Hence, China could not secure a favourable outcome in the iron ore pricing issue by resorting to her overall power dominance via a linkage strategy.

Nonetheless, the Chinese actors also attempted to manipulate asymmetrical sensitivity interdependence as a bargaining strategy. Australian pricing initiatives led to Chinese countermeasures during the negotiation periods to drive down the ore prices. For instance, the Chinese steel makers resorted to bargaining techniques such as initiating a collective trade embargo against Australian iron ore imports with the aim of forcing the Australian mining giants to lower the iron ore import prices. The Chinese presumed the Australian companies would be sensitive to the impact of the Chinese boycott. However, this action turned out to be in vain. This was because the Chinese steel industry could not sustain any long period of boycott action, as the steel mills could not afford to allow steel production and operation to be disrupted for long. It was apparent that the Chinese had seriously miscalculated the patterns of asymmetrical sensitivity interdependence vis-à-vis the Australians.

Similarly, miscalculation over the underlying patterns of vulnerability also led to a misguided Chinese attempt to promote a Chinese model for the benchmark price negotiation regime. The model was designed in accordance with Chinese preferences and was therefore thought to be favourable to national interests. However, this endeavour ended in disaster because the Chinese negotiators either pushed forward with scant regard for the underlying patterns of asymmetrical vulnerability interdependence, or seriously misjudged the power relationship defined by asymmetrical vulnerability interdependence between the Chinese steelmakers and the Australian (and Brazilian) mining companies. By contrast, the Australians eventually succeeded in imposing their preferred index-based short-term pricing regime upon the ore buyers because the favourable underlying patterns of asymmetrical vulnerability interdependence allowed them to replace the old pricing regime that was no longer deemed the most efficient arrangement for profit maximisation for the ore suppliers. As Keohane and Nye pointed out, ‘coherent strategies must be based on the underlying patterns of vulnerability interdependence; otherwise, an attempt to manipulate asymmetrical sensitivity interdependence without regard for underlying patterns of vulnerability is likely to fail’ (Keohane & Nye, 2011: 14).

If anything, the iron ore pricing war illustrated the subjugation of the Chinese steel industry by the Australian mining companies in the political economy of iron ore trade. The vast power disparities between the Chinese ore buyers and the Australian ore suppliers enabled the latter to profit immensely from the lucrative ore business by taking advantage of the Chinese vulnerability. From a geopolitical perspective, such inequitable terms of resource trade were consistent with the changing nature of the geopolitical ties between the two countries. Like the resource investment ties, the resource trade relationship had also grown out of a delicate and precarious geopolitical framework. Hence, the revived strategic tensions and even growing adversarial dynamics observed in recent years in the bilateral strategic relationship rendered the broader political context increasingly difficult for the development of a truly equitable and harmonious partnership, based on the vital and massive resource trade. In this regard, employing the theoretical framework, the movement towards the realist end along the continuum between the ideal types of complex interdependence and realism, could only make the nature of resource trade ties even more precarious and conflict-ridden between China and Australia, as they might evolve to become two strategic adversaries.

The chapter also contains a brief discussion of Chinese attempts to reduce the level of vulnerability in the ore pricing struggle. The predicament in the iron ore issue taught the Chinese a painful lesson about over-dependence on the dominant foreign iron ore suppliers. In the face of surging ore prices, Chinese sentiment was galvanised to look for ways to reduce their dependence on the Australian (and Brazilian) mining companies. They attempted to do so by expanding domestic iron ore production and therefore increasing indigenous iron ore supplies, diversifying their sources of iron ore import, and forestalling the developments leading to further concentration of market power by Rio Tinto and BHP Billiton over iron ore trade. However, such efforts were not sufficient to undermine the dominant market power of the three mining giants or significantly help to reduce Chinese dependence on them in the short term.

Notably, the steel mills also ventured into overseas resource investment and acquisition projects. The general aim was to enhance Chinese control of the upstream mining industry and enhance influence over major mineral resources. The Chinese government also undertook a series of policy adjustments to facilitate investment in overseas resource sectors including the iron ore mining business. In this regard, Chinese resource investment in Australia was very much driven by the same market imperative and geo-economic considerations. However, the aggressive overseas investment spree has yet to significantly enhance Chinese steel industry’s ability to control raw material costs any time soon. Insofar as the Australian theatre was concerned, the Chinese investment and acquisition efforts encountered huge regulatory barriers and unforeseen operational hurdles that acted to greatly thwart Chinese ambitions, as discussed in the previous chapter. Whilst those above-mentioned measures were essentially supply-side strategies to reduce Chinese dependence on the major iron ore suppliers, the next chapter will look into the demand-side strategies the Chinese used to tackle their vulnerability in the iron ore pricing war. It will go on to examine in depth how various domestic economic constraints significantly contributed to Chinese vulnerability in the battle for pricing power, as well as explain why it was so difficult for the Chinese to get rid of those domestic constraints under complex interdependence.

# Chapter 5 Chinese Predicament in the Iron Ore Struggle: Internal Fragmentation and Structural Economic Constraints

## 5.1 Introduction

The previous chapter briefly discussed the ways in which the Chinese endeavoured to reduce the country's dependence on the three dominant mining companies. Efforts to increase China's indigenous iron ore supplies and Chinese-owned iron ore assets abroad were all supply-side strategies aimed at undermining the three mining oligarchs' monopoly of iron ore supply, as well as to strengthen China's market power. However, the surging price of imported iron ore was also attributable to China's rigid and rapidly growing demand for iron ore; to a large extent, domestic constraints also contributed to Chinese weakness in the transnational struggle against the mining companies for pricing power. In no small measure, the issue of iron ore price emerged as a spill over from domestic economic problems. In order to achieve a deeper understanding of the domestic dimension of the Chinese vulnerability in the iron ore war, this chapter analyses the domestic constraints by mainly focusing on two major issues: the chaos in China's iron ore import market; and the steel industry's structural problems centred on overcapacity. These two domestic constraining factors considerably aggravated the Chinese predicament in the iron ore struggle, by propping up Chinese demand for imported iron ores and depressing steelmakers' profit margins. By examining these domestic sources of China's predicament, this chapter hopes to shed light on the enormous domestic obstacles to enhancing Chinese power position in the iron ore price struggle.

This chapter begins with a brief discussion of how rampant speculation in the iron ore spot market undermined China's bargaining position in the price negotiations and some of the major industry actions to curb the speculative trading activities. The next section explains the limited effectiveness of the anti-speculation measures undertaken by the Chinese industry actors, by looking into the political economy and the market dynamics of the Chinese iron ore import sector. The subsequent section addresses the other major domestic constraint by exploring how the problem of overcapacity contributed to the Chinese steel industry's growing sensitivity to price hikes and entrenched vulnerability in the transnational price negotiations.

Having considered the domestic dimension of China's transnational battle with Australia for iron ore pricing power, this chapter asserts that domestic economic constraints could seriously complicate Chinese efforts to manipulate asymmetrical interdependence and eradicate vulnerability in the iron ore pricing war against the Australian mining companies. This observation is important for understanding the sources of Chinese vulnerability in the transnational power struggle. An analysis of the domestic sources of Chinese vulnerability is not only necessary for understanding the roles and interests of the various Chinese actors involved in the struggle for pricing power, but also extremely crucial for understanding China's disadvantageous power position vis-à-vis Australia and why the various Chinese endeavours in the transnational power politics of resource trade have always failed to enhance China's bargaining power. Hence, although the analytical focus of this chapter concentrate on the domestic sphere, it nonetheless constitutes an integral part of the empirical analysis of this whole thesis, going some way to addressing the research question and some of the research objectives of this thesis, as outlined in Chapter 1.

This chapter argues that, amongst other factors, internal fragmentation amongst the market actors in China's iron ore import sector and the structural problem of overcapacity facing the Chinese steel industry, constituted the two major domestic factors that contributed to Chinese vulnerability in the resource politics vis-à-vis Australia. By elaborating on the domestic sources of Chinese vulnerability, the findings of this chapter reinforce the thesis' core argument that China has to cope with her vulnerability despite her growing power in the bilateral resource politics vis-à-vis Australia.

The interest fragmentation and lack of internal coherence amongst the Chinese market actors demonstrates one of the typical problems under complex interdependence. According to Keohane and Nye, internal fragmentation in terms of pluralisation of interests and multiplicity of actors will undermine a state's ability to manipulate asymmetrical interdependence: 'states that are better placed to maintain their coherence… will be better able to manipulate uneven interdependence than fragmented states that at first glance seem to have more resources in an issue area' (Keohane & Nye, 2011: 29).

This theoretical insight of complex interdependence is most evident in the analysis of the internal incoherence of the Chinese steel industry and iron ore import sector, which arguably reinforced Chinese vulnerability in the iron ore pricing struggle. China's enhanced market status and financial power appeared to have brought about an improvement in her power position vis-à-vis the Australia ore suppliers. However, because of the pluralistic patterns of actors involved and the divergent interests at stake, the Chinese industry actors remained incapable of maintaining their coherence in the collective struggle against the Australian mining companies. Notably, the divergent interests amongst the various state-owned and private market actors of the Chinese steel industry – as well as infighting between the steel industry actors and the minerals trading community – clearly demonstrated how internal fragmentation jeopardised Chinese efforts to curb rampant speculative trading, and undermined the strength of some of the collective bargaining strategies used against the Australian mining oligarchs in the price negotiations.

## 5.2 Chaos and Rampant Speculation in Iron Ore Import Market

A major culprit behind China's inability to win price concessions from the mining companies was the rampant speculation in imported iron ores in China. Iron ore speculation was lucrative business when demand for iron ore was high and when the downstream steel market was booming. Speculators were able to easily accrue profits from exploiting the huge differential between the high spot market price and the relatively much lower long-term contract benchmark price. Large Chinese steel mills made a fortune by preying on the numerous small steel mills. They possessed the iron ore import qualifications and access to long-term contracts ores from the big mining companies. Huge profits were made by buying the cheaper long-term contract ores at the benchmark prices from the iron ore producers and reselling the extra long-term contract ores on China's spot market to other Chinese buyers, such as the numerous small- and medium-sized steel producers or the large number of iron ore speculators trading in the spot market.

By convention, Vale, Rio Tinto and BHP Billiton would only sign long-term supply contracts with big end-users of iron ores, i.e., the big steel mills (Yin & Fan & Li, 2009: 114). However, the three big iron ore producers had reportedly begun to sign long-term contracts with some small- and medium-sized Chinese steel mills and even mineral trading companies amidst the deadlock in the 2009 price negotiation.[211] Nonetheless, in general, only those large steel mills had direct access to long-term contract ores from the three big producers; and China's mineral import and export companies by and large were unable to buy and import long-term contract ores directly from the three largest mining companies because they themselves were not the consumers of iron ores.[212]

China's small- and medium-sized steel producers had no direct access to long-term contract ores. Lacking iron ore import qualifications they were barred from buying and importing iron ores from overseas mining companies in the first place. It was virtually impossible for those small players, most of whom were private businesses, to obtain iron ore import qualifications. Hence, China's iron ore import qualification system had effectively prohibited China's small steel mills from importing the cheaper

[211] Source: 'Defecting Small and Medium Steel Mills Signed Deals with Vale' (June 10, 2009) http://finance.sina.com.cn/chanjing/cyxw/20090610/06526327518.shtml

[212] Ibid.

long-term contract ores.

Apart from the large steel mills that possessed iron ore import qualifications, China's mineral import and export companies could also profit easily in the Chinese iron ore market. These mineral trading companies acted as middlemen between the end users of iron ore (i.e., the steel mills, especially the numerous small to medium-sized ones) and the iron ore producers (for those with iron ore import qualifications) or iron ore importers (for those without iron ore import qualifications). Some large mineral import and export companies with iron ore import qualifications had direct access to imported spot market ores;[213] they would resell their imported spot market ores to steel mills (that had no iron import qualifications) or other numerous small iron ore import companies (that did not possess import qualifications but were engaged in the iron ore resale business). The rest of China's iron ore trading companies that did not have iron ore import qualifications could not directly import any iron ores; they had no choice but to buy imported iron ores from the large importers in China's spot market;[214] these small trading companies active in the spot market would either sell iron ores to China's small steel mills or resell the ores to other intermediate iron ore traders that engaged in the iron ore resale business.[215]

With the participation of the numerous small steel mills competing for imported iron ores, China's iron ore spot market became the largest in the world[216] (Richard, 2010; Yang, 2010: 136). The aggregate output of China's hundreds of small- and medium-sized steel mills collectively accounted for more than half of

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[213] A number of large resource trading companies were able to obtain the iron ore import qualifications. They mainly bought and imported spot market iron ores from the Indian and other foreign ore producers (Yang, 2010: 137; Yin & Fan & Li, 2009: 61). Vale, Rio Tinto and BHP Billiton were also increasingly engaged in China's spot market trading apart from selling long-term contract ores. Source: 'Secret Wars of Iron Ore Negotiation Escalated As Global Giants and Chinese Play Their Three Trump Cards' (December 30, 2009) http://news.sohu.com/20091230/n269293820.shtml

[214] To be more specific, those mineral trading companies could only buy second-hand long-term contract ores from the large steel mills or spot market ores resold by the large qualification-holding mineral trading companies.

[215] See: http://finance.sina.com.cn/chanjing/gsnews/20090701/02596422075.shtml;
http://www.cnstock.com/paper_new/html/2010-04/13/content_11311.htm;
http://m.nbd.com.cn/articles/2009-07-01/223514.html;
http://www.chinaweekly.cn/bencandy.php?fid=63&aid=4310&page=4;
http://m.nbd.com.cn/articles/2009-07-01/223514.html

[216] Source: 'Mining Industry Espionage: How Did Rio Tinto Obtain Chinese Steel Mills' Secrets' (July 16, 2009) http://finance.sina.com.cn/chanjing/sdbd/20090716/12246488733.shtml

the country's national steel output[217] (Dou & Tang, 2009: 135). As these steel producers were effectively barred from buying long-term contract ores, they were forced to flock into the spot market for supplies of imported ores, creating a gigantic demand for spot market ores.[218]

As the imported long-term contract and spot market ores changed hands in the spot market, their prices would be raised accordingly on each occasion. Hence, the imported iron ores were eventually sold at much higher prices than their original import prices to the numerous small- and medium-sized steel mills, increasing the procurement costs for these end customers. The steel mills reportedly had to pay a high premium of 50-100 percent for those second-hand and third-hand ores amidst tight supply.[219] As a result of these speculative market dynamics, spot market prices for imported ores were propped up. When the iron ore market was booming, speculative demand was also strong and rising. In anticipation of further growth in the (spot market) prices, a significant proportion of long-term contract ores were imported for speculative stockpiling and sales. Hence, China's iron ore demand was amplified by the speculative demand, which would further accentuate the phenomenon of supply shortages and contribute to the high spot market prices.

The rampant speculation in iron ore imports had undermined China's bargaining position in the benchmark price talks and weakened her ability to check the rise in benchmark prices for long-term contract ore supplies. The speculative demand increased Chinese demand for imported iron ores, strengthened the mining companies' case for strong Chinese ore demand and also provided the ammunition to the ore producers arguing for benchmark price rises.[220]

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[217] Source: 'Problem of Overcapacity Re-emerged in Steel Industry' (June 26, 2009) http://finance.sina.com.cn/chanjing/cyxw/20090626/18406406637.shtml

[218] Source: 'Chinese Camp Put to Rout By the Three Giants As Small- and Medium-sized Steel Mills Excluded from Iron Ore Negotiations Benefits' (June 24, 2009) http://www.china.com.cn/economic/txt/2009-06/24/content_18000332_2.htm

[219] See various reports on the high premiums: http://news.sina.com.cn/c/sd/2010-03-15/112419866977.shtml; http://www.shbiz.com.cn/Item/107885.aspx; http://m.nbd.com.cn/articles/2009-07-01/223514.html; http://finance.qq.com/a/20090710/004060.htm

[220] See: http://epaper.jinghua.cn/html/2006-09/13/content_66392.htm; http://china.cnr.cn/jryw/200908/t20090801_505417959.html; http://jjckb.xinhuanet.com/cjxw/2009-07/31/content_172324.htm

During the heyday of iron ore speculation, the lucrative prospects also induced some (if not many) Chinese steel mills to curry favour with the mining companies and beg them for long-term contract ores. In some cases, the sales representatives of the iron ore producers were bribed into selling long-term contract ores;[221] some Chinese steel mills' procurement staff had reportedly bribed the mining companies with sensitive information on the Chinese steel industry and commercial secrets that helped the companies determine the bottom line of their Chinese rivals at the negotiation table and the margin of price rise that would maximise their interests.[222]

From the perspective of the CISA, the rise in spot market demand and the speculative trading were the major sources of China's fatal vulnerability in the annual benchmark price negotiations.[223] In the tense arguments dividing the Chinese negotiators and the iron ore producers in the successive price talks from 2004 onwards, what it all boiled down to was China's actual market demand for iron ores and the country's strong and growing spot prices. From the producers' perspective, the strong spot market prices revealed the true market value and demonstrated that China's steelmakers had huge demand for iron ore imports, and had the ability to absorb further rises in raw material costs.[224]

In order to curb the rampant speculative activities, The CISA implemented various measures to rectify import market order, including the introduction of a national iron ore import commission system and the establishment of the filing and monitoring system for the iron ore import business.[225]

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[221] See: http://www.infzm.com/content/42939; http://finance.qq.com/a/20090710/004060.htm; http://finance.sina.com.cn/chanjing/sdbd/20090824/15016656617.shtml; http://business.sohu.com/20100327/n271133165.shtml; http://focus.news.163.com/10/0325/11/62K9GU5R00011SM9.html

[222] See: http://finance.sina.com.cn/chanjing/sdbd/20090716/12246488733.shtml; http://finance.sina.com.cn/chanjing/cyxw/20090714/13476477967.shtml; http://finance.ifeng.com/news/special/lituo/20100805/2482554.shtml; http://finance.ifeng.com/news/special/lituo/20100805/2482554.shtml; http://finance.sina.com.cn/chanjing/sdbd/20090716/12246488733.shtml

[223] Source: 'Iron Ore Import Market Needs Re-ordering' (July 16, 2009) http://jjckb.xinhuanet.com/gd/2009-07/16/content_169722.htm

[224] See: http://www.ftchinese.com/story/001031313?full=y; http://mnc.people.com.cn/GB/7932766.html; http://mnc.people.com.cn/GB/10202348.html; http://epaper.jinghua.cn/html/2006-09/13/content_66392.htm

[225] Source: 'China Ends Iron Ore Import Chaos by Strict Import Commissioning System' (July 31, 2009) http://www.china.com.cn/news/txt/2009-07/31/content_18245203.htm

The filing and monitoring system served a record-keeping function. Before executing a deal, Chinese iron ore importers were obliged to submit the information about their iron ore imports to the Ministry of Commerce, with regard to the quantity, origins, uses, quality and sales data, etc. The CISA and the CCCMC established a joint office under the supervision of the Commerce Ministry to collect information on the import contracts, which were submitted by the qualified iron ore importers on a regular basis.[226] The primary purpose of the filing system was to enable the industry watchdogs to monitor and keep track of the domestic destinations of the imported iron ores and to make sure they would go to the steel mills for steelmaking rather than being resold and traded for speculative purposes.[227]

The filing rules were drawn up to complement the import commissioning system, which was the main thrust of the CISA's efforts to curb spot market speculation and was intended to work in tandem with the iron ore import qualification framework. Under the iron ore import commissioning system, all qualified iron ore importers (i.e., iron ore import qualification holders) were prohibited from 'selling' their imported iron ores to other domestic Chinese buyers. The qualified importers were entrusted to import iron ores on behalf of those steel mills that had no iron ore import qualifications. They were allowed to earn import commission for their service as import agents; but any attempts to resell imported ores at a price were strictly banned. Only a maximum of 3-5 percent commission based on FOB (free-on-board) pricing could be charged for providing the service. Iron ore importers could only charge a maximum of 3 percent commission for members of the CISA or the CCCMC Iron Ore Sub-Chamber and a maximum of 5 percent for non-members.[228]

The import commissioning system also banned the qualified iron ore importers from procuring imported iron ores for non-steel producers; i.e., only the end users of iron ores (steel mills) were allowed to entrust the qualified iron ore importers to import iron ores, and all the intermediate minerals trading companies were completely denied access to imported iron ores from the qualified iron ore importers under the

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[226] Source: 'CISA and CCCMC Set Up Joint Office to Crack Down On Speculation' (April 6, 2010) http://news.xinhuanet.com/fortune/2010-04/06/c_1218376.htm

[227] Ibid.

[228] Ibid.

commissioning system. Moreover, the commissioning parties were also banned from reselling the imported ores they obtained from the qualified iron ore importers to other domestic buyers: the imported ores should only be used for the steel mills' own steelmaking activities, and any attempts to resell those ores to any third parties would constitute a breach of the rules.[229]

The commissioning system and the total ban on reselling were supposedly designed to reduce the scope for speculative trading in the spot market. Under this system, China's numerous small- to medium-sized steel mills that had no iron ore import qualifications could obtain the relatively cheaper long-term contract ores direct from the qualified ore importers (mainly the large steel mills) via the commissioning arrangement; as a result, they would cut out the numerous minerals import and export trading companies that had been acting as the middlemen between them and the qualified iron ore importers. If the rules were put in place, the imported long-term contract ores were prohibited from being resold to non-producing trading firms on the spot market. The regime would give speculators no room to profit by taking advantage of the price differentials between the long-term contract and spot market ores.[230] The whole group of minerals import and export trading companies would be marginalised and eventually driven out of the iron ore import and trading business except for a handful of large qualification-holding resource trading companies.[231]

In fact, the commissioning mechanism was arguably designed to suppress the spot market (trading) altogether. In an ideal situation (at least from the perspective of the CISA), if speculative trading could be curbed, spot market ore supplies would decline, demand for spot market ores would fall (and even disappear), and the spot market would shrink accordingly; and if spot market trading could be eliminated altogether, the long-term contract benchmark price would thus face less upward pressure.[232]

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229 Source: 'CISA and CCCMC Set Up Joint Office to Crack Down On Speculation' (April 6, 2010) http://news.xinhuanet.com/fortune/2010-04/06/c_1218376.htm

230 See: http://finance.people.com.cn/GB/9769452.html; http://www.nbd.com.cn/articles/2011-03-17/533957/print; http://jjckb.xinhuanet.com/gnyw/2009-03/04/content_146970.htm; http://china.cnr.cn/jryw/200908/t20090801_505417959.html; http://jjckb.xinhuanet.com/cjxw/2009-07/31/content_172324.htm; http://www.chinanews.com/cj/cj-gncj/news/2009/09-03/1849406.shtml

231 Interview: 48

232 See: http://mnc.people.com.cn/GB/10917205.html;

The CISA also worked with the CCCMC to cut the number of qualified iron ore importers by tightening the criteria used for assessing the qualified importers. The management of the iron ore import qualification regime was overseen by the Ministry of Commerce; but in practice the industry associations had a big say in the formulation of the specific assessment criteria and were delegated to undertake the specific tasks of preparing and executing the import qualification system.[233] Over the years, the CISA worked in partnership with the CCCMC to raise the standards for iron ore import qualification with respect to the applicant's annual iron ore imports volume, its annual steel output (if it was a steel mill) or registered capital (if it was an import and export trading company), among other threshold criteria.[234]

There were 523 companies engaged in iron ore import before the qualification system was in place. This number was reduced to 118 (with 70 steel mills and 48 import and export trading companies) in 2005 after the qualification mechanism was put in place (Li July 15, 2009). The number of qualified iron ore importers was further reduced to 116 in 2006 and 112 in 2007(Cao July 16, 2009). By 2010, the number was cut down to 105.[235] By imposing more stringent barriers to market entry, the CISA was seeking to further limit the number of qualified iron ore importers, including the minerals import and export trading companies, which had been accused of aggravating the problem of speculation.[236]

The Chinese also stepped up efforts to crack down on speculative stockpiling. Growing dock stockpiles at the ports helped reinforce the mining companies' argument for a strong Chinese demand for ore, and

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http://www.cnstock.com/paper_new/html/2007-10/30/content_59464088.htm;
http://mnc.people.com.cn/GB/126636/10917437.html

[233] Source: 'Criteria and Application Procedure for Iron Ore Import Enterprise Qualification (Draft)' (May 11, 2005) http://finance.sina.com.cn/chanjing/b/20050511/12021578391.shtml

[234] See: http://finance.sina.com.cn/chanjing/b/20050511/12021578391.shtml;
http://www.mofcom.gov.cn/article/wtojiben/t/200503/20050300019797.shtml;
http://money.163.com/13/0615/07/91D4VLE8002526O5.html

[235] Source: 'Criteria and Application Procedure for Iron Ore Import Enterprise Qualification (Draft)' (May 11, 2005) http://finance.sina.com.cn/chanjing/b/20050511/12021578391.shtml

[236] See: http://finance.sina.com.cn/chanjing/cyxw/20090731/06576553105.shtml;
http://www.nbd.com.cn/articles/2009-07-14/226948/print;
http://money.163.com/13/0615/07/91D4VLE8002526O5.html;
http://news.xinhuanet.com/fortune/2010-04/06/c_1218376.htm

seriously weakened the bargaining position of the Chinese negotiators.[237] In 2006 and 2008, the Chinese government ordered the relevant parties to clear out their iron ore stockpiles at China's iron ore ports.[238] The joint order issued by the National Development and Reform Commission, the Ministry of Transport, the Ministry of Railways, and the Ministry of Commerce required iron ore importers and buyers to clear away their respective dock stockpiles; the directive also instructed port authorities, railways authorities, the CISA and CCCMC to speed up iron ore delivery and to take steps to prevent excessive stockpiles at ports. The Chinese government also ordered the port authorities to raise the storage charges whilst banning all minerals trading companies from speculative stockpiling at the ports and selling iron ores to those steel mills contrary to the Steel Industry Development Policy (Zhang May 28, 2008). These *ad hoc* policy measures were aimed to suppress speculative demand and curb excess ore imports. In the heyday of iron ore speculation, mountains of iron ores were stockpiled at the docks, as imported ores were deliberately held there anticipation of price rises.[239]

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[237] See: http://finance.people.com.cn/GB/1038/7272580.html; http://money.163.com/09/0715/04/5E845UDK00252G50.html

[238] See: http://www.cnstock.com/newcjzh/headine/2008-05/23/content_3345405.htm; http://finance.people.com.cn/GB/1037/7285173.html

[239] See: http://mnc.people.com.cn/GB/7784840.html; http://finance.people.com.cn/GB/1037/7285173.html; http://www.cnstock.com/paper_new/html/2010-04/13/content_11311.htm; http://finance.sina.com.cn/chanjing/cyxw/20090610/06526327518.shtml

## 5.3 Limited Effectiveness of the Anti-speculation Measures

The CISA's efforts to curb speculative activities failed to remove the chaos from iron ore import market. In practice, the institutionalisation and enforcement of the iron ore import commissioning and filing regimes faced tremendous difficulties and resistance.[240] The CISA, together with the CCCMC, had been trying to lay down specific rules for the commissioning and filing systems for years. A series of industry policy documents and self-regulatory conventions were promulgated successively since 2005. Basically carrying the same effect under different titles,[241] those documents supposedly reflected the common position of the steel industry and the concerned minerals trading companies.[242] In practice, they had never had their wholehearted support. The rules had been introduced and put in place, but were never completely followed nor seriously complied with.[243] The fact that it had taken a gargantuan effort by the CISA and the CCCMC to reinstate and give legitimacy to these rules over the years demonstrated how difficult it had been for the iron ore import commissioning system (and to a lesser extent the filing system) to be fully implemented and enforced on the ground.

The iron ore import commissioning regime failed to deliver the intended results. In particular, the 3-5 percent commission rule was never truly complied with by the qualified importers.[244] The large steel mills and the resource trading companies that had import qualifications would procure iron ore imports on behalf of the domestic buyers, but they would charge an additional 30-50 percent for reselling these

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240 See: http://mnc.people.com.cn/GB/15369836.html; http://jjckb.xinhuanet.com/gnyw/2009-03/04/content_146970.htm; http://finance.sina.com.cn/chanjing/cyxw/20110318/04549552925.shtml; http://www.chinanews.com/cj/2011/08-02/3228283.shtml

241 Source: 'CISA Authority Questioned: Difficulty in Implementing Iron Ore Import Commissioning Regime' (August 9, 2011) http://mnc.people.com.cn/GB/15369836.html

242 Source: 'Iron Ore Trade to Be Regulated By Import Qualification' (December 30, 2006) http://www.acs.gov.cn/sites/aqzn/aqjxnr.jsp?contentId=2334899127371

243 Source: 'CISA Authority Questioned: Difficulty in Implementing Iron Ore Import Commissioning Regime' (August 9, 2011) http://mnc.people.com.cn/GB/15369836.html

244 See: http://www.chinaweekly.cn/bencandy.php?fid=63&aid=4310&page=4; http://focus.news.163.com/10/0325/11/62K9GU5R00011SM9.html; http://m.nbd.com.cn/articles/2009-07-01/223514.html; http://news.sina.com.cn/c/sd/2010-03-15/112419866977.shtml; http://www.shbiz.com.cn/Item/107885.aspx; http://finance.qq.com/a/20090710/004060.htm; http://money.163.com/09/0721/02/5ENC8BFD002524SO.html; http://www.china.com.cn/economic/txt/2009-06/24/content_18000332_2.htm

imported ores to other domestic buyers[245] (Zhang July 1, 2009). Nor had the qualified iron ore importers abided by the rules by restricting their clients to the steel mills only: the imported iron ores would be sold to other minerals trading companies and could have changed hands several times before reaching their end users.[246] When the imported iron ores were eventually resold to the end users (the steel mills) from those minerals trading companies, the ore prices could increase by more than 50 percent of the original import prices (Zhang July 1, 2009). Despite the introduction of the import filing system, the industry associations in practice were unable to keep track of where those ores would go or how many times the imported ores had changed hands in the market.

The iron ore import qualification system was effective in limiting the 'nominal' number of legal iron ore importers because importers without the official qualifications were not able to clear the imported ores through customs. However, the arrangement failed to reduce the number of 'shadow' iron ore importers[247] (Zhang July 1, 2009). The qualification system was set up to increase the barriers to entry; but in practice, many iron ore trading companies could find ways to bypass the restrictions and remain in business[248] (Zhang July 1, 2009; Yin & Fan & Li, 2009: 113, 177). Moreover, the number of qualified iron ore importers had been reduced from 523 before 2005 to 105 by 2010; but from 2010 onwards, there had been no further cuts to the number of qualified importers despite the CISA's efforts to raise the bar on assessment criteria for iron ore import qualification application in more recent years.

Given the poor implementation of the iron ore import regimes, there were no obvious improvements in import market order. On the contrary, the problem of speculation in imported iron ores had been to some

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[245] Source: 'Rio Tinto Arraigned – Iron Ore "Is Black"' (March 25, 2010)
http://focus.news.163.com/10/0325/11/62K9GU5R00011SM9.html

[246] See: http://www.chinatimes.cc/pages/moreInfo1.htm?id=129083;
http://finance.sina.com.cn/chanjing/gsnews/20090701/02596422075.shtml;
http://www.cnstock.com/paper_new/html/2010-04/13/content_11311.htm;
http://m.nbd.com.cn/articles/2009-07-01/223514.html;
http://www.chinaweekly.cn/bencandy.php?fid=63&aid=4310&page=4;
http://m.nbd.com.cn/articles/2009-07-01/223514.html; http://money.163.com/09/0701/05/5D440M1900253B0H.html

[247] See: http://focus.news.163.com/10/0325/11/62K9GU5R00011SM9.html;
http://www.chinanews.com/cj/cj-gncj/news/2010/04-29/2253284.shtml

[248] See: http://www.cnstock.com/paper_new/html/2008-06/19/content_61980292.htm;
http://mnc.people.com.cn/GB/7400442.html; http://222.66.115.81/xbsite/html/2006-09/31531.html

extent aggravated by the regimes.[249] Without full compliance, the iron ore import commissioning system was actually self-defeating. It denied China's steel mills that had no iron ore import qualifications direct access to iron ore imports, by forcing them to procure imported ore supplies only from those qualification-holding large steel mills and a handful of qualified large minerals trading companies. In this way, the commissioning arrangement actually made it easier for the qualified iron ore importers to profit through speculative trading. Rather than bringing order and checking speculation, the iron ore import qualification mechanism actually created a situation more conducive to speculation. The iron ore import qualifications had turned out to be a prerogative of those qualified large state-owned steel mills and resource trading companies that were able to enjoy all the benefits of the a *de facto* import monopoly by abusing their exclusive import privileges[250] (Yin & Fan & Li, 2009: 115, 118).

### 5.3.1 Too Tempting to Resist

There were a number of factors that accounted for the failure to restore order in the chaotic iron ore import market. In the absence of powerful enforcement mechanisms, the profit-seeking speculators could hardly be expected to practise self-discipline and exercise self-regulation by abiding by the rules of the industry associations and cooperating with the relevant authorities in the campaign to wipe out iron ore speculation.[251] On the contrary, there were strong incentives for speculators to take advantage of the institutional weaknesses and abuse the loopholes in the iron ore import regimes to continue with their speculative activities. Most importantly, speculative profits were so high that they were too tempting to give up.[252] The qualified iron ore importers were unwilling to forego the chance to profit through

[249] Source: 'Chinese Investigate Iron Ore Import and Seek to Revoke 30 Import Qualifications' (July 15, 2009) http://finance.sina.com.cn/chanjing/cyxw/20090715/01496480864.shtml

[250] See: http://finance.sina.com.cn/review/observe/20100813/01078473464.shtml; http://www.chinaweekly.cn/bencandy.php?fid=63&aid=4310&page=4; http://info.finance.hc360.com/2008/04/140729104021.shtml; http://www.chinatimes.cc/pages/moreInfo1.htm?id=129083; http://news.sina.com.cn/c/sd/2010-03-15/112419866977.shtml; http://money.163.com/09/0721/02/5ENC8BFD002524SO.html; http://www.ce.cn/cysc/newmain/jdpd/zjxw/200908/10/t20090810_19558374.shtml

[251] Source: 'CISA Authority Questioned: Difficulty in Implementing Iron Ore Import Commissioning Regime' (August 9, 2011) http://mnc.people.com.cn/GB/15369836.html

[252] See: http://mnc.people.com.cn/GB/15369836.html; http://www.dfdaily.com/html/113/2011/7/31/638656.shtml; http://news.xinhuanet.com/fortune/2006-07/11/content_4817827.htm;

speculative trading (Yin & Fan & Li, 2009: 113). For many large steel mills, the lure of quick speculative profits was formidable because selling iron ore was more profitable than producing steel[253] (Yin & Fan & Li, 2009: 113). Nor would the numerous small- and medium-sized minerals trading companies readily withdraw from the lucrative business as middlemen and concede the iron ore import market to the big qualified importers altogether.[254]

At the same time, the speculators saw no strong incentives to give up speculation in the spot market. On the one hand, to put an end to speculative trading in the spot market would supposedly help the Chinese negotiators in the long-term contract price talks; if the long-term contract benchmark prices could be lowered, it would in turn benefit the large steel mills that relied heavily on long-term contract ore supplies. On the other hand, the large steel mills had no strong incentive to forsake the tangible huge speculative profits for the uncertain and intangible benefits expected to be derived from a reduction in speculative trading in the spot market. From the individual firm's perspective, if it could not be assured that speculative trading would be halted completely across the entire industry, there would be no incentive for the individual steel producer to practise self-discipline; to do so would only put the firm at a disadvantage while others continued to make profit from speculative trading.[255]

### 5.3.2 Inadequate Market Deterrence

Speculative trading could be risky, but the risks were often considered too small to deter its practice. Most of the qualification-holding iron ore importers were large state-owned steel mills and resource trading companies with very deep pockets and a high risk tolerance; they were more willing and prepared to take risks by engaging in risky speculative stockpiling when iron ore prices were high and rising.

Furthermore, during the 2003-2008 period, when the rise in raw material costs could be more or less

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http://www.chinanews.com/cj/cj-gncj/news/2010/04-29/2253284.shtml

[253] See: http://finance.qq.com/a/20090710/004060.htm; http://m.nbd.com.cn/articles/2009-07-01/223514.html

[254] See: http://m.nbd.com.cn/articles/2009-07-01/223514.html;
http://news.xinhuanet.com/fortune/2006-07/11/content_4817827.htm

[255] Source: 'Steel Industry Deep Throat: Speculation More Profitable Than Steelmaking' (July 10, 2009)
http://finance.sina.com.cn/roll/20090710/04086463792.shtml

completely transferred to steel buyers and absorbed by downstream consumers and sectors[256] (Yin & Fan & Li, 2009: 99, 119), the steel mills that used long-term contract ores did not in fact have to worry too much about the rising benchmark prices. Hence, the large steel mills had not in actuality been held back by the growing costs of long-term contract ore supplies, nor by the fact that rampant speculation would undermine efforts to bring down the benchmark prices. To some extent, the lucrative business of speculative trading had considerably reduced the large steel mills' sensitivity to the surging prices of the long-term contract ores, since they could easily pass on the rising costs to the numerous small- and medium-sized steel mills by selling the long-term contract ors at a profit. When the costs of iron ores started to eat into the steel mills' profits beginning in 2009, it even became an added incentive for the large steel mills to engage in speculative trading in order to make up for the extra loss due to the rising costs of the long-term contract ores.[257]

### 5.3.3 Institutional Defects

Furthermore, the proposed iron ore import commissioning regime did not seem to have taken into full consideration the practical risks faced by the individual importers and commissioning parties. From the perspective of risk compensation, the maximum 3-5 percent commission fee was too small to match and hedge against the potential market risks that would be faced in the process. If the qualified iron ore importers were to completely observe the rules of the import commissioning system, they would have to bear huge risks by importing iron ores on behalf of the commissioning parties, while subject to the uncertainty of the iron ore market and the instability in the downstream steel market. As a result, the qualified iron ore importers were by no means keen to take risks by obeying the 3-5 percent commission

[256] See: http://finance.sina.com.cn/stock/jsy/20070307/17033385202.shtml;
http://info.finance.hc360.com/2007/11/22073091762.shtml;
http://www.chinaweekly.cn/bencandy.php?fid=63&aid=4310&page=3;
http://www.cs.com.cn/xwzx/01/68/200802/t20080219_1370827.htm;
http://news.cctv.com/china/20080222/100883.shtml;
http://www.sasac.gov.cn/n1180/n1271/n20515/n2697206/12403998.html;
http://www.chinatimes.cc/site1/hxsb/html/2009-07/25/content_25126.htm

[257] See: http://finance.sina.com.cn/chanjing/sdbd/20090716/12246488733.shtml;
http://www.eeo.com.cn/eeo/jjgcb/2009/07/20/144301.shtml;
http://www.ce.cn/cysc/newmain/jdpd/zjxw/200908/10/t20090810_19558374.shtml;
http://www.shbiz.com.cn/Item/107885.aspx

rule.[258]

Meanwhile, China's small- to medium-sized steel producers had yet to place their trust in the import commissioning regime and the large steel mills with iron ore import qualifications. Because of their competitive relationship, the smaller steel mills (especially those which were private businesses) were by no means completely reassured to leave their overseas iron ore supplies in the trust of the large state-owned steel mills, which collectively dominated and effectively monopolised China's iron ore imports.[259] In theory, the import commissioning regime would give the small steel producers access to the long-term contract ores; in practice, the regime was used by the large state-owned steel producers to exploit their small private sector competitors.[260] Hence, the import commissioning system could not even win the support of China's small- and medium-sized steel mills, which were supposed to be the largest beneficiaries of the mechanism.[261]

## 5.3.4 Institutional Weakness of the CISA

The CISA was not powerful enough to exercise supervision over the iron ore import business. Despite its central role in initiating the industry efforts to eradicate speculative behaviour, the CISA's institutional profile and regulatory capacity were far too limited to ensure thorough enforcement of the rules. The operation of the iron ore import commissioning and filing regimes faced tremendous practical difficulties on the ground. Notwithstanding the fact that the CISA was one of those most powerful industry associations in China with close association with the government, but it could not alone manage the whole process and handle resistance from the industry itself. Despite its semi-governmental role in the steel industry, it was not a statutory agency and had no statutory mandate to regulate the Chinese steel

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[258] Source: 'Failure of Iron Ore Import Commissioning Regime Calls CISA's Authority into Question' (August 9, 2011) http://mnc.people.com.cn/GB/15369836.html

[259] See: http://jjckb.xinhuanet.com/gnyw/2009-03/04/content_146970.htm; http://mnc.people.com.cn/GB/126636/15369853.html

[260] See: http://m.nbd.com.cn/articles/2009-07-01/223514.html; http://www.chinaweekly.cn/bencandy.php?fid=63&aid=4310&page=4; http://finance.sina.com.cn/chanjing/cyxw/20090610/06526327518.shtml

[261] Source: 'Failure of Iron Ore Import Commissioning Regime Calls CISA's Authority into Question' (August 9, 2011) http://mnc.people.com.cn/GB/15369836.html

industry. Its rules were neither administrative orders nor had statutory status, and the enforcement of its rules basically relied on self-discipline on the part of the individual firms.[262] The CISA also lacked the administrative resources and the policy authority to perform an oversight and enforcement role, even with the backing of the Ministry of Commerce.

The association had no real power to punish those companies that violated its rules. The CISA claimed that it had the authority to suspend and even cancel the iron ore import qualifications of those actors whose behaviour constituted a breach of CISA rules against speculative trading;[263] however, that power was conditional upon the consent and support of the Ministry of Commerce, which was the ultimate statutory agency overseeing the iron ore import qualification regime.[264] Moreover, the CISA could not constrain the behaviour of the large and powerful state-owned enterprises, particularly those national corporations, despite their CISA membership and nominal consent to the CISA's leadership.[265] The CISA had no real leverage or authority to regulate the behaviour of China's hundreds of private steel mills that did not (and could not) join the CISA.[266] Nor did it have the authority over China's numerous minerals import and export companies that were in the custody of the CCCMC and other trade associations.[267] In short, as an industry association, the CISA could hardly be expected to play the role of a government

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[262] See:
http://mnc.people.com.cn/GB/126636/10917437.html;http://www.dfdaily.com/html/113/2011/7/31/638656.shtml; http://mnc.people.com.cn/GB/126636/15369853.html; http://www.chinanews.com/cj/2011/08-02/3228283.shtml

[263] See: http://mnc.people.com.cn/GB/15369836.html; http://www.dfdaily.com/html/113/2011/7/31/638656.shtml; http://www.eeo.com.cn/2009/0801/146350.shtml;
http://finance.sina.com.cn/chanjing/cyxw/20090611/05576333191.shtml;
http://finance.people.com.cn/GB/11292652.html

[264] See: http://finance.sina.com.cn/chanjing/b/20050511/12021578391.shtml;
http://www.chinatimes.cc/site1/hxsb/html/2009-07/25/content_25123.htm
http://mnc.people.com.cn/GB/126636/15369853.html
http://magazine.caijing.com.cn/2011-06-26/110757015.html

[265] See: http://www.chinanews.com/cj/cj-gncj/news/2010/04-29/2253284.shtml;
http://epaper.jinghua.cn/html/2006-09/13/content_66392.htm; http://stock.sohu.com/20090709/n265086581.shtml; http://news.sohu.com/20090717/n265275360.shtml; http://www.eeo.com.cn/eeo/jjgcb/2009/07/20/144301.shtml; http://info.finance.hc360.com/2008/04/140729104021.shtml; http://www.shbiz.com.cn/Item/107885.aspx

[266] See: http://www.chinanews.com/cj/cj-gncj/news/2010/04-29/2253284.shtml;
http://mnc.people.com.cn/GB/126636/15369853.html

[267] See: http://www.chinanews.com/cj/cj-gncj/news/2010/04-29/2253284.shtml;
http://mnc.people.com.cn/GB/15369836.html; http://epaper.jinghua.cn/html/2006-09/13/content_66392.htm

regulator and to carry out a task which should have been undertaken by the relevant government agencies.

### 5.3.5 CISA's Hidden Agenda and Acquiescence to Speculative Trading

The CISA's real attitude towards speculative trading in imported iron ores was questionable in the first place. The industry association had arguably adopted a tolerant stance towards the speculative behaviour of the big state-owned steel mills that were profiting from speculative trading in the long-term contract ores. It had been intent on shutting its eyes to the widespread speculative buying and selling activities of those qualification-holding steel mills, which were made up the core membership of the CISA. Since the CISA represented only the interests of China's state-owned steel mills, it had a vested interest in protecting the interests of its core members, even if the latter were profiting from speculation.[268]

Indeed, until approximately 2009, the CISA's real attitude towards speculating trading in long-term contract ores by its core members was tantamount to acquiescence.[269] Arguably, the rising costs of long-term contract ores had yet to threaten to erode the profit margins and competitive advantage of China's big state-owned steel producers in the pre-2009 period; the CISA in practice therefore took a fairly relaxed attitude towards the growing speculative behaviour of its core members profiting from trade in long-term contract ores, even if the intensified speculation had gradually come to be regarded as a source of China's difficulty in the benchmark price talks.

*Discrimination against Private and Small Steel Mills*

Speculation in imported iron ores would eventually increase the costs of raw materials significantly for China's small- and medium-sized steel mills. Because it solely acted on behalf of the state-owned steel producers, the CISA had no particular concern for the interests and survival of those hundreds of small- and medium-sized steel mills, most of which were private businesses[270] (Yin & Fan & Li, 2009: 107,

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[268] See: http://news.sina.com.cn/c/sd/2010-03-15/112419866977.shtml; http://www.chinatimes.cc/site1/hxsb/html/2009-07/25/content_25123.htm

[269] See: http://business.sohu.com/20090714/n265193683.shtml; http://news.sohu.com/20090717/n265275360.shtml

[270] See: http://finance.qq.com/a/20090714/000561.htm; http://stock.sohu.com/20090709/n265086581.shtml

159).

Since the beginning of the 2000s, the booming steel market led to a rapid growth of the private sector in China's steel industry[271] (Yin & Fan & Li, 2009: 91, 108; Dou & Tang, 2009: 135, 172, 189). The plethora of private steel producers and the rapid expansion of their market share arguably posed a threat to the state-sector. China's policymakers and state-owned steel mills by and large had a somewhat discriminatory attitude towards the private steel mills[272] (Yin & Fan & Li, 2009: 26, 112).

The hostility and bias against the private steel mills was enshrined in government policy. In official industrial planning and key industry policies, the country's numerous small steelmakers from the private sector were seen as part of the structural problems faced by the steel industry[273] (Yin & Fan & Li, 2009: 110). Private steel mills were accused of adding excessive production capacity to the industry, bringing down the industry's concentration ratio, producing more pollution and consuming more resources, and aggravating the problem of oversupply (of low-end steel products).[274] From the perspective of the government policymakers and the big state-owned steel producers, the growing Chinese private steelmaking sector was not a genuine cause for celebration; rather, it was something that needed to be discouraged because they believed that the steel industry's future should only lie in the development and strengthening of the state-sector.[275]

On the specific issue of imported iron ores, the statist view was that the country's numerous small private

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[271] See: http://finance.sina.com.cn/chanjing/cyxw/20090626/18406406637.shtml; http://special.sci99.com/201405/sp274.html

[272] See: http://guancha.gmw.cn/content/2007-08/24/content_660877.htm; http://finance.sina.com.cn/review/observe/20050723/16071828378.shtml

[273] See: http://finance.sina.com.cn/review/observe/20050723/16071828378.shtml; http://news.xinhuanet.com/fortune/2013-08/06/c_125121937.htm; http://www.chinatimes.cc/hxsb/special/7year/140718/1407182208-136549.html; http://finance.sina.com.cn/review/20090531/10346284795.shtml; http://news.xinhuanet.com/fortune/2005-05/08/content_2928196.htm

[274] Source: 'Private Steel Mills Once Again under Pressure to Conserve Energy and Reduce Emissions' (June 29, 2007) http://www.cncscs.org/view.asp?id=186

[275] See: http://finance.sina.com.cn/review/20090531/10346284795.shtml; http://finance.sina.com.cn/review/observe/20050723/16071828378.shtml

steel mills generated excess demand for iron ores and created the world's largest spot market, which had undermined the industry's competiveness and collective bargaining power, undercut the Chinese efforts in the benchmark price negotiations, and contributed to China's vulnerability in the national struggle against the foreign iron ore suppliers. Hence, the central government and the state-owned enterprises had no sympathy for the plight of the private steel mills[276] (Yin & Fan & Li, 2009: 112, 117); instead, there was tacit collusion between the central government, the state-owned steel mills (especially the largest), and the CISA against the country's private steel producers.

Discrimination against private steelmaking businesses was present in the iron ore qualification system. The ostensible reason for the introduction of the import qualification system was to cut the number of China's iron ore importers in order to enhance the Chinese buyers' collective bargaining power vis-à-vis the mining companies because the plethora of importers had led to competitive bidding for the import contracts and pushed up ore prices.[277] The import qualification regime was later viewed as a mechanism that would help to reduce speculation by driving further cuts in the qualified iron ore importers, particularly the resource import and export trading companies. However, the regime's unstated agenda was to enhance the state-owned steel mills' control of imported iron ore supplies so as to force the private steelmakers to buy the more expensive imported ores resold on the spot market by the qualified state-owned steel mills.[278] By denying the small private steelmakers direct access to imported iron ores (whether long-term contract ore or first-hand spot market ores), the iron ore import qualification system effectively made it much tougher for the small steel mills to obtain imported iron ores and considerably increased their raw material costs[279] (Yin & Fan & Li, 2009: 91). In fact, the unstated strategy was to deprive the small private steel mills control of the supply of their raw materials and increase their

[276] See: http://finance.qq.com/a/20090710/004060.htm;
http://finance.sina.com.cn/chanjing/sdbd/20090716/12246488733.shtml;
http://www.eeo.com.cn/eeo/jjgcb/2009/07/20/144301.shtml;
http://finance.sina.com.cn/chanjing/cyxw/20090610/06526327518.shtml

[277] See: http://www.infzm.com/content/31485;
http://finance.sina.com.cn/chanjing/cyxw/20090715/01496480864.shtml;
http://epaper.jinghua.cn/html/2006-09/13/content_66392.htm; http://mnc.people.com.cn/GB/15369836.html;
http://news.sohu.com/20090717/n265275360.shtml

[278] See: http://www.chinatimes.cc/pages/moreInfo1.htm?id=129083; http://www.shbiz.com.cn/Item/107885.aspx

[279] See: http://finance.sina.com.cn/chanjing/cyxw/20090715/01496480864.shtml;
http://mnc.people.com.cn/GB/7400442.html

difficulties in the steelmaking business.[280] Indeed, the ultimate objective was to gradually drive the small private steelmakers out of the business[281] (Yin & Fan & Li, 2009: 112).

In the light of the implicit collective efforts against the private steelmaking businesses, the CISA had never wholeheartedly pushed ahead with its reform efforts to crack down on speculative trading in the long-term contract ores by the large steel mills during the pre-2009 period. As those speculative activities would eventually help eliminate the industry's 'backward production capacity' in the private sector contrary to the requirements of the government's industry policy, the CISA was thus not overly keen to expend serious efforts to eradicate iron ore speculation. In effect, the import qualification system (and the malfunctioning import commissioning regime) had encouraged speculative trading and exploitation of the small- and medium-sized private steelmakers[282] (Yin & Fan & Li, 2009: 115, 118); this in turn had suppressed the development of the private steelmaking sector and enhanced the dominance of the state-owned enterprises in the steel industry.

Only in the post-2009 years did the CISA begin to change its approach due to deteriorating economic circumstances. Moreover, from 2009 onwards, the CISA had assumed a role as the lead Chinese negotiator at the benchmark price talks, replacing Baosteel. Henceforth, the CISA was held directly accountable for bringing down benchmark prices in the price talks[283] (Yin & Fan & Li, 2009: 98). As the representative of the state sector of China's steel industry, the CISA could no longer afford to close its

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[280] See: http://jjckb.xinhuanet.com/gnyw/2009-03/04/content_146970.htm; http://mnc.people.com.cn/GB/126636/15369853.html

[281] See: http://www.ce.cn/cysc/newmain/jdpd/zjxw/200908/10/t20090810_19558374.shtml; http://finance.sina.com.cn/g/20090802/05216559632.shtml; http://news.sohu.com/20090717/n265275360.shtml; http://finance.qq.com/a/20090710/004060.htm; http://news.sina.com.cn/c/sd/2010-03-15/112419866977.shtml

[282] See: http://finance.sina.com.cn/chanjing/cyxw/20090715/01496480864.shtml; http://www.chinatimes.cc/pages/moreInfo1.htm?id=129083; http://www.ce.cn/cysc/newmain/jdpd/zjxw/200908/10/t20090810_19558374.shtml; http://news.sina.com.cn/c/sd/2010-03-15/112419866977.shtml; http://www.chinanews.com/cj/cj-gncj/news/2010/04-29/2253284.shtml; http://www.modernweekly.com/content.aspx?artID=30032; http://money.163.com/09/0721/02/5ENC8BFD002524SO.html; http://m.nbd.com.cn/articles/2009-07-01/223514.html; http://www.chinaweekly.cn/bencandy.php?fid=63&aid=4310&page=4

[283] Source: 'Iron Ore Negotiations Reach Impasse: CISA's Hard-line Approach Accused of Imcompetence' (July 9, 2009) http://stock.sohu.com/20090709/n265086581.shtml

eyes to the rampant speculation in imported iron ores. Even speculative trading by its core members had to be curbed in order to protect the collective interests of China's state-owned steel mills in the intensified battle over long-term contract ores against the Australian and Brazilian mining companies.[284]

*Bias against the Minerals Trading Community*

At the same time, the CISA's tolerant attitude towards the steel mills stood in stark contrast to its unforgiving posture towards the mineral trading companies. The steel industry association had its eye on the mineral import and export companies, which were accused of being the primary culprits responsible for the chaos in the spot market. From to the CISA's perspective, China's large and small minerals trading companies should be held responsible for the growing speculative trading in the spot market and the resultant surge in spot market prices.[285] However, the steel industry's accusations met with firm rebuttals and resentment from the Chinese minerals trading community. The resource trading companies and their own industry association, the CCCMC, refused to accept responsibility for the import market disorder. On the contrary, they blamed the mess on the steelmakers and the CISA themselves. The minerals traders pointed to the declining proportion of the iron ores imported by the minerals import and export trading companies in China's total iron ore imports over the recent years; and they also stressed the fact that it was mainly those large steel companies that were engaging in the speculative trading in long-term contract ores (since the ore producers signed long-term contracts mainly with top steel mills and generally did not deal with the import-export merchants directly).[286] In fact, the CCCMC felt that the minerals trading community had been made a scapegoat for the large steelmakers' greed and the CISA's

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284 Source: 'Iron Ore Negotiation Stagnated as Baosteel Led the Speculation in Spot Market' (July 17, 2009) http://www.eeo.com.cn/eeo/jjgcb/2009/07/20/144301.shtml

285 See: http://business.sohu.com/20100406/n271324208.shtml; http://finance.sina.com.cn/chanjing/sdbd/20100426/16297828628.shtml; http://www.infzm.com/content/44129; http://finance.sina.com.cn/chanjing/cyxw/20100429/02147847030.shtml; http://news.xinhuanet.com/fortune/2006-07/11/content_4817827.htm; http://finance.sina.com.cn/chanjing/cyxw/20090611/05576333191.shtml; http://www.eeo.com.cn/2009/0825/149262.shtml

286 See: http://finance.sina.com.cn/chanjing/sdbd/20100426/16297828628.shtml; http://www.cnstock.com/paper_new/html/2010-04/13/content_11311.htm; http://business.sohu.com/20100406/n271324208.shtml; http://finance.sina.com.cn/chanjing/sdbd/20100426/16297828628.shtml; http://www.eeo.com.cn/2009/0825/149262.shtml

incompetence.[287] The growing grievances of the minerals merchants suggested that, despite its professed determination to take on speculators and restore import market order, in reality the CISA had been fiercely protective towards the large steel mills in the face of steelmakers' speculative activities on the ground.[288]

*Conflicts between the CISA and the CCCMC: Divergent Interests*

It took the combined efforts of both the CISA and the CCCMC to restore market order in the iron ore import business. However, the CISA and the CCCMC were reluctant partners at best; although the CCCMC was an indispensible partner in this endeavour, the CISA had never seen eye to eye with the CCCMC. The two industry leaders had not been on good terms with each other since the beginning of their collaboration on iron ore import qualification and commissioning regimes.[289] Having divergent views on who should apportion the largest share of responsibility for the chaos, their cooperation remained grudging and minimal. Indeed, the CISA and the CCCMC had never managed to come to a genuinely common position on how to deal with speculative trading.[290] The persistence of iron ore speculation, surging iron ore prices and the deterioration of the steel industry's operational environment, further increased tension between the two associations.

The growing tension and mutual mistrust between the CISA and the CCCMC was most acutely demonstrated in a joint iron ore meeting in 2010. During the 'CISA-CCCMC Joint Meeting on Restoring Iron Ore Market Order', a bitter argument broke out between the CISA and the CCCMC about who had

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[287] See: http://www.eeo.com.cn/2009/0825/149262.shtml; http://www.sxcoal.com/ironsand/596216/articlenew.html

[288] See: http://www.chinatimes.cc/site1/hxsb/html/2009-07/25/content_25123.htm; http://finance.sina.com.cn/chanjing/cyxw/20100406/07527693615.shtml; http://news.sina.com.cn/c/sd/2010-03-15/112419866977.shtml

[289] See: http://business.sohu.com/20100406/n271324208.shtml; http://finance.sina.com.cn/chanjing/sdbd/20100426/16297828628.shtml; http://www.chinatimes.cc/site1/hxsb/html/2009-07/25/content_25123.htm

[290] See: http://www.eeo.com.cn/2009/0825/149262.shtml; http://www.china.com.cn/economic/txt/2011-03/18/content_22167293.htm; http://finance.sina.com.cn/chanjing/cyxw/20110318/04549552925.shtml; http://finance.sina.com.cn/roll/20090717/21436496528.shtml

the ultimate responsibility for the surging iron ore import prices.[291] At the meeting, the CISA and the steel mills stepped up their attack on the minerals trading community and increased pressure on the trading companies to abide by the rules of the import commissioning system. Accused of violating the rules prohibiting importers from selling imported ores to non-producing customers, the trading companies were pressured not to engage in speculative multiple resale trading. The big qualified minerals trading companies were warned that further breaches of the iron ore import rules would lead to the revocation of their iron ore import qualifications. Given their irreconcilable differences the joint meeting broke down acrimoniously and led to a walkout by the CCCMC representatives in protest of the CISA's unfair treatment.[292]

The outburst of anger by the CCCMC captured the minerals traders' resentment towards the CISA's discriminatory stance and 'selfish' agenda.[293] The trading community was in fact suspicious of the CISA's real motives: by attributing the blame squarely to the import trading companies, the CISA and the steelmakers were actually seeking to drive the minerals merchants out of the iron ore import and trading business altogether, so that the large steel mills would be able to enjoy a complete collective monopoly on the import business. There had been months of speculation in 2009 about a possible cut in qualified iron ore importers by as much as 30, most of which were minerals import trading companies.[294] Indeed, the iron ore import qualification system seemed to be inherently directed at the minerals trading companies.

The responsibility to draw up the annual iron ore import qualification application criteria was a source of power. The CISA was not willing to share that power with the CCCMC because of the tremendous industry and organisational interests that were at stake; nor would the CCCMC readily give that up and

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[291] See: http://finance.sina.com.cn/chanjing/sdbd/20100426/16297828628.shtml; http://business.sohu.com/20100406/n271324208.shtml

[292] See: http://www.china.com.cn/economic/txt/2011-03/18/content_22167293.htm; http://finance.sina.com.cn/chanjing/cyxw/20110318/04549552925.shtml

[293] Source: 'Chen Haoran: Iron Ore Import Companies Being Made the Scapegoats' (August 25, 2009) http://www.eeo.com.cn/2009/0825/149262.shtml

[294] See: http://finance.sina.com.cn/chanjing/cyxw/20090715/01496480864.shtml; http://www.modernweekly.com/content.aspx?artID=30032; http://business.sohu.com/20090714/n265193683.shtml; http://finance.people.com.cn/GB/9679887.html

surrender its authority. Given their persistent mistrust and deepening acrimony, the two industry associations had to make compromises and perform balancing acts;[295] this had significantly undermined Chinese efforts to tackle the market disorder and weakened Chinese bargaining position.[296] For instance, the above-mentioned conflict between the CISA and CCCMC resulted in a serious delay in releasing a key regulatory document in 2010 because of the huge resistance to the new arrangement from the CCCMC and the minerals trading companies.[297]

### 5.3.6 Ambiguity of Government Stance

The CISA itself did not possess the authority to withdraw iron ore import qualifications from the minerals traders; it would have to rely on the Ministry of Commerce to back up its authority over the minerals trading companies.[298] A radical overhaul of the spot market was impossible without the endorsement of the Ministry of Commerce.

However, the Ministry of Commerce arguably had a vested interest in promoting trade and preserving the trading community's interests.[299] The Commerce Ministry was the natural government custodian of the international and domestic minerals trading companies, especially those state-owned merchant

[295] See: http://www.cnstock.com/paper_new/html/2007-09/25/content_59209434.htm; http://finance.sina.com.cn/chanjing/sdbd/20100426/16297828628.shtml; http://www.chinatimes.cc/site1/hxsb/html/2009-07/25/content_25123.htm; http://finance.sina.com.cn/roll/20090717/21436496528.shtml; http://epaper.jinghua.cn/html/2006-09/13/content_66392.htm

[296] See: http://finance.sina.com.cn/chanjing/sdbd/20100426/16297828628.shtml; http://business.sohu.com/20100406/n271324208.shtml; http://www.chinatimes.cc/site1/hxsb/html/2009-07/25/content_25123.htm

[297] See: http://www.china.com.cn/economic/txt/2011-03/18/content_22167293.htm; http://finance.sina.com.cn/chanjing/cyxw/20110318/04549552925.shtml

[298] See: http://mnc.people.com.cn/GB/126636/15369853.html; http://www.chinatimes.cc/site1/hxsb/html/2009-07/25/content_25123.htm; http://magazine.caijing.com.cn/2011-06-26/110757015.html; http://finance.sina.com.cn/chanjing/b/20050511/12021578391.shtml

[299] See: http://news.sina.com.cn/c/sd/2010-03-15/112419866977.shtml; http://www.chinatimes.cc/site1/hxsb/html/2009-07/25/content_25123.htm; http://finance.sina.com.cn/chanjing/cyxw/20110318/04549552925.shtml; http://www.china.com.cn/economic/txt/2011-03/18/content_22167293.htm

companies that were the Ministry's close political and economic associates. The CCCMC also came under the direct management of the Commerce Ministry.[300] In this regard, the CISA could not completely fall back on the support of the Commerce Ministry. Arguably, the CISA had received only dubious endorsement from the Ministry of Commerce in its efforts to crack down on iron ore speculation.[301] Notably, Commerce Ministry could hardly be expected to wholeheartedly support the CISA by banning all trading companies from engaging in the iron ore trade.[302] The slow progress in implementing and enforcing the iron ore commissioning regime was also arguably a result of a lack of enthusiasm on the part of the Ministry of Commerce for the project.[303]

The steelmaking industry's plight was not a direct concern for the Commerce Ministry. The rising raw materials costs and the deteriorating earnings performance of the steel industry were the pressing issues for other government stakeholders including the Ministry of Industry and Information Technology and the National Development and Reform Commission[304] (Yin & Fan & Li, 2009: 74-76, 112). In fact, the CISA had been formerly associated with the NDRC.[305] Nowadays, the work of the CISA came under the direct supervision of the State-Owned Assets Supervision and Administration Commission.[306] The senior

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300 See: http://www.cccmc.org.cn/skjj/skzc/index.htm; http://finance.sina.com.cn/chanjing/cyxw/20110318/04549552925.shtml; http://www.china.com.cn/economic/txt/2011-03/18/content_22167293.htm

301 See: http://finance.sina.com.cn/chanjing/cyxw/20110318/04549552925.shtml; http://www.china.com.cn/economic/txt/2011-03/18/content_22167293.htm; http://finance.china.com.cn/news/gnjj/20130618/1560092.shtml

302 Source: 'Commerce Ministry Disapproves CISA's Proposal to Revoke Import Qualifications' (July 25, 2009) http://www.chinatimes.cc/site1/hxsb/html/2009-07/25/content_25123.htm

303 Source: 'New Regulations to Be Introduced to Rectify Chaos in Iron Ore Import Market' (October 30, 2007) http://www.cnstock.com/paper_new/html/2007-10/30/content_59464088.htm

304 See: http://news.china.com.cn/txt/2011-03/09/content_22089227.htm; http://finance.sina.com.cn/chanjing/cyxw/20100406/07527693615.shtml; http://www.gov.cn/zwgk/2009-05/14/content_1314437.htm; http://finance.sina.com.cn/roll/20090717/21436496528.shtml; http://business.sohu.com/20100327/n271133165.shtml; http://money.163.com/09/0721/02/5ENC8BFD002524SO.html; http://money.163.com/special/view12/

305 See: http://www.infzm.com/content/44126; http://news.china.com.cn/txt/2011-03/09/content_22089227.htm

306 See: http://www.chinaisa.org.cn/gxportal/DispatchAction.do?efFormEname=ECTM40&key=VjVaZVkyUjNUNVdgXjlVNFM3CWlUMAcxBDQIPVE1BzoFFghHDBcENAEQAEdfSARm; http://www.infzm.com/content/44126

management of the CISA were staffed by officials appointed by and affiliated with the SASAC.[307] By and large, the interests of these powerful government agencies were more aligned with those of the CISA on the iron ore issue; but they could not push forward with the CISA's agenda by directly interfering with the work of the Commerce Ministry with respect to trade issues. After all, the Commerce Ministry was the designated lead government agency for the task of restoring market order for the iron ore import business.[308] The subtle relationships between these four government agencies were important contextual variables shaping China's response in the struggle over iron ore prices and determining the extent to which the CISA could push ahead with its reform programmes.

However, regardless of which government regulatory agency was involved, none were eager to adopt an overtly active posture of direct intervention in the iron ore import market. Chinese policymakers were afraid of inviting foreign accusations of political interference with market prices[309] (Yin & Fan & Li, 2009: 76). On several occasions Chinese officials even went to some lengths to make a disctinction between the official government policy and the policy of the industry associations, ostensibly to keep the industry associations' efforts at arm's length.[310] The Chinese authorities were after all sensitive to foreign allegations of protectionist policy and government interference in the free market.[311] The government was even more concerned that high-profile government interventions in international (iron ore) trade and transnational business engagement might lead to inter-state trade conflicts with Australia and other nations. And in the face of China's growing resource investment in Australia in particular, any direct and overt government interference with the sensitive iron ore business could easily spark wider business and political tensions that could very well spill over into the investment arena and further complicate China's

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[307] Source: 'Doubt over CISA's Status' (April 22, 2010) http://www.infzm.com/content/44126

[308] See: http://finance.sina.com.cn/chanjing/cyxw/20110318/04549552925.shtml; http://www.china.com.cn/economic/txt/2011-03/18/content_22167293.htm; http://jjckb.xinhuanet.com/xwjc/2009-01/15/content_138808.htm

[309] See: http://news.xinhuanet.com/fortune/2007-10/31/content_6976399.htm; http://www.infzm.com/content/44129; http://bgt.mofcom.gov.cn/article/c/f/200908/20090806462392.shtml; http://business.sohu.com/20100327/n271133165.shtml

[310] See: http://epaper.dfdaily.com/dfzb/html/2010-04/16/content_229404.htm; http://finance.china.com.cn/news/gnjj/20130618/1560092.shtml; http://magazine.caijing.com.cn/2011-06-26/110757015.html

[311] Source: 'CISA Admits Iron Ore Negotiation Ceases to Exist in Reality, MIIT Contemplates New Import Mechanism' (April 16, 2010) http://business.sohu.com/20100416/n271551114.shtml

resource investment push in Australia's iron ore and other minerals mining sectors.

Nonetheless, there had been instances of overt Chinese government attempt to influence the price negotiations[312] (Yin & Fan & Li, 2009：74-76). For instance, the Ministry of Commerce and the NDRC issued a joint statement just prior to the fourth round of the 2006 price talks, stating that the Chinese government was highly concerned about the price negotiation that had been under way. The Commerce Ministry unequivocally asserted that if the Chinese government found the benchmark prices unacceptable, it reserved the right to take all necessary measures to deal with the situation because the Chinese steel industry could no longer bear further rises in the costs of (imported) iron ores (Yin & Fan & Li, 2009: 76).

This assertive official statement immediately triggered reactions from both the Australian and Brazilian governments. The Australian Federal Resource Minister responded that the Australian government would be very concerned and alarmed by any attempts by the Chinese government to impose a price ceiling on Australian iron ore exports to China; and that the Australian government did not rule out further interventions if necessary. The Brazilian government urged the Chinese government to clarify its official position on whether it would consider direct intervention in the iron ore price talks (Yin & Fan & Li, 2009: 76).

The escalation of the inter-governmental conflict was however short-lived as all sides had successively declared and reaffirmed the principle of non-intervention. The Chinese Commerce Ministry also quietly revised its previous public statement and removed those insistent if not threatening remarks. The Chinese Premier and the NDRC Chairman also ruled out the possibility of direct Chinese government intervention in the price talks while being interviewed by foreign media. The Australian Department of Foreign Affairs and Trade (DFAT) also expressed the same position afterwards (Yin & Fan & Li, 2009: 76).

[312] See: http://news.xinhuanet.com/fortune/2007-10/31/content_6976399.htm; http://business.sohu.com/20100327/n271133165.shtml; http://business.sohu.com/20100327/n271133165.shtml; http://finance.sina.com.cn/chanjing/cyxw/20100406/07527693615.shtml; http://www.infzm.com/content/44129

In April 2010, the CISA initiated a boycott of the long-term contract ores from the three big mining companies and imposed a ban on the import of low-grade iron ores in April 2010.[313] Officials from the MIIT's Industry Policy Department suggested that those decisions (to prohibit the import of low grade iron ore and to call a halt to the import of iron ores from the mining giants) taken by the steel industry associations were not 'government policy'.[314]

313 See: http://business.sohu.com/20100416/n271551114.shtml; http://business.sohu.com/20100416/n271551114.shtml

314 Source: 'Iron Ore Negotiation under Threat from the Stock Depletion in June' (April 16, 2010) http://epaper.dfdaily.com/dfzb/html/2010-04/16/content_229404.htm

## 5.4 Structural Adjustments of the Steel Industry

### 5.4.1 Accounting for the Diminishing Earnings Performance

Surging iron ore costs had reduced the profit margins of the Chinese steelmakers. No less significant than the burden of increased raw material cost was diminishing Chinese steel demand due to the slowing down of the Chinese economy. Even before the outbreak of the global financial and economic crises, the Chinese economy had already begun to slow down, resulting in falling domestic demand for steel since the second half of 2008.[315] In particular, the Chinese government's effort to curb property speculation started taking effect by the beginning of 2008.[316] The cooling of the Chinese housing market in turn impinged on demand in the steel market. With the rapid decline in investment and widespread suspension of new construction projects in the real estate sector, steel prices began to fall.[317] Given the decline in domestic demand, the trading volume of steel products shrank and steel inventories went up towards the end of 2008. When the impact of the global financial crisis eventually set in, the market condition deteriorated even further as the Chinese economy was hard hit by the global financial and economic disturbances, and foreign demand for Chinese-made steel also plunged. China's steel industry was therefore plagued by the plunge in both domestic and overseas steel demand during the crisis and in its immediate aftermath.

Since the second quarter of 2009, China's stimulus policy gave the Chinese steel market a strong boost and helped ameliorate the pressure on steelmakers.[318] However, the stimulus package did not address the structural weaknesses in the Chinese economy. By 2010, the effect of the stimulus policy began to diminish.[319] Beginning from 2010, domestic demand for steel products dropped once again as

[315] See: http://www.ems86.com/touzi/html/?62632.html; http://www.solar588.com/view.asp?types=hydt&id=329; http://theory.people.com.cn/GB/49154/49155/9133892.html

[316] See: http://www.iceo.com.cn/column/26/2012/0302/242825.shtml; http://www.china.com.cn/economic/txt/2009-01/08/content_17076980.htm; http://finance.sina.com.cn/leadership/mroll/20101011/14468758127.shtml

[317] See: http://info.machine.hc360.com/2008/10/15114351642.shtml; http://mnc.people.com.cn/GB/8132401.html

[318] See: http://www.csteelnews.com/csteelnews/xwbd/djbd/201209/t20120906_73660.html; http://local.china.com.cn/2012-10/08/content_26721563.htm; http://mnc.people.com.cn/GB/10662413.html; http://focus.news.163.com/09/0113/16/4VI5F9JH00011SM9.html

[319] See: http://www.cnstock.com/v_news/sns_jd/201407/3084845.htm; http://theory.people.com.cn/n/2014/0417/c40531-24908255.html

investment in the property market and infrastructure projects (such as the national high speed railway network) stagnated and fell. A new round of government efforts (beginning from 2010) to cool the housing market dealt a heavy blow to the steel market.[320] A significant proportion of the RMB¥4 trillion stimulus package aimed to deliver infrasture construction projects. These infrastructure investments focused heavily on the transportation infrastructures such as the construction of railways, highways and airports.[321] However, this infrastructure investment spree driven by the stimulus policy also began to lose momentum and reduced demand for steel as the majority of the construction projects had neared completion by 2010 or 2011.[322] From 2011 onwards, China's economy experienced an almost continuous and steady decline in quarterly GDP growth.[323] Slowing economic expansion, compounded by the government's efforts to steer the economy away from heavy dependence on investment towards consumption-driven growth, forestalled a full recovery of the Chinese steel market. The slowing down of manufacturing activities across the steel-intensive sectors (such as the ship building industry, automobile industry, and appliance industry, etc.) further weakened the steel market. Having fallen from the post-crisis peak in late 2009 and early 2010, prices of steel products declined steadily with the deteriorating macroeconomic environment and market situation.[324] In the face of rising raw material costs, falling steel prices (since mid-2010) and weak steel demand, China's steelmakers experienced

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320 See: http://www.chinanews.com/estate/estate-lspl/news/2010/05-26/2304027.shtml; http://magazine.caixin.com/2010-05-16/100144209.html; http://finance.ifeng.com/stock/bk/20100517/2193421.shtml; http://finance.sina.com.cn/stock/hyyj/20100601/09398036938.shtml

321 See: http://www.chinanews.com/cj/cj-gncj/news/2009/05-21/1702615.shtml; http://finance.people.com.cn/GB/10274329.html

322 See: http://money.163.com/10/1203/07/6MVB6OIO00253EOR.html; http://finance.people.com.cn/GB/15177847.html; http://www.scio.gov.cn/xwfbh/gbwxwfbh/xwfbh/jcb/Document/839552/839552.htm; http://politics.people.com.cn/GB/1026/13652260.html; http://m.ftchinese.com/story/001033658; http://www.xcf.cn/jrdd/201110/t20111025_194625.htm; http://finance.sina.com.cn/zl/china/20140817/101120034608.shtml; http://www.ftchinese.com/story/001051451?full=y

323 See: http://www.stats.gov.cn/tjsj/zxfb/201101/t20110120_12689.html; http://www.stats.gov.cn/tjsj/zxfb/201201/t20120117_12777.html; http://www.stats.gov.cn/tjsj/zxfb/201301/t20130118_12924.html; http://www.stats.gov.cn/tjsj/zxfb/201401/t20140120_502082.html; http://www.stats.gov.cn/tjsj/zxfb/201501/t20150120_671037.html

324 http://finance.qq.com/a/20111220/001435.htm; http://news.steelcn.cn/a/104/20120702/556029FA6D4050.html; http://news.xinhuanet.com/futures/2013-05/30/c_124785543.htm; http://finance.china.com.cn/industry/energy/gtys/20140909/2663493.shtml

rapidly diminishing profit margins and falling earnings. Given the sluggish steel demand, it had become much harder to pass on the rising raw materials costs to downstream buyers by raising steel prices.

The bleak outlook for the steel industry was exacerbated by the sector's structural problems, which had seriously undermined the competitiveness and profitability of China's steel industry. Overcapacity, especially for low-end steel production (Dou & Tang, 2009: 50), was arguably the most serious and urgent structural problem among those 'chronic illnesses' facing the industry. Excessive investment and redundant capacity in the steel industry had become a serious policy issue long before the 2008-2009 crisis (Dou & Tang, 2009: 1, 143-150); but like the problem of rising iron ore price, its damaging implications had not posed a serious threat to the industry's profitability and earnings until the steel boom went bust. Once the growth of the Chinese economy and steel demand lost steam, the problems of excess steel capacity and over-supply were immediately accentuated (Dou & Tang, 2009: 1-3, 189). Over-investment led to excess steel capacity. Rapid expansion of steel production capacity in turn led to explosive growth in the steel output, which not only pushed up demand and prices for imported iron ores, but also significantly worsened the situation of over-supply of steel products and exerted downward pressure on steel prices, thereby encouraging vicious price competition. Hence, the problem of overcapacity exacerbated the problem of surging raw material costs and significantly worsened the market prospects for steelmakers.

### 5.4.2 Chronic Overcapacity and Excessive Investment

The Chinese government had been trying to carry out structural reforms to curb excess capacity and consolidate China's steel industry. As seen from China's 'Iron and Steel Industry Development Policy' (NDRC July 8, 2005), the 'Iron and Steel Industry Adjustment and Revitalisation Plan' (State Council March 20, 2009) and the latest '12th Five-Year Development Plan for Iron and Steel Industry' (MIIT October 24, 2011), there were a series of government directives aimed at tackling the structural problems facing the industry. Among other objectives, the government was seeking to curb excess investment and overcapacity in the sector, raise the concentration ratio and promote upward and downward vertical integration.[325] A variety of policy instruments had been used to tackle the problems of overcapacity and

[325] Deepened vertical integration would enhance the steel industry's control over upstream resource supply and costs,

excess investment. However, despite repeated government efforts to push ahead with the various reform agendas, those structural problems persisted because of some rather formidable difficulties.

Steel capacity was easy to build and expand but hard to cut down and dismantle. Excess capacity could not be brought down overnight in response to falling steel demand and prices. To make matters worse, the post-crisis years saw further increases in steel capacity, partly as a result of the stimulus policy.[326] Investment in steel capacity was also continuing into the post-crisis period despite government warnings of over-supply and efforts to curb excess capacity.[327] Although the steel industry had the lowest average gross profit margin among all industrial sectors in China, the steel sector's annual fixed asset investment in recent years had persistently reached the levels of around RMB¥400-500 billion.[328] According to the CISA, China's production capacity of crude steel reached 850 million tons approximately by the end of 2011, whilst actual crude steel output in 2011 was only 683.88 million tons.[329]

As the country underwent the phase of national-wide urbanisation and intensive industrialisation, China's demand for steel products was in no small measure driven by the property market boom and the investment in infrastructure projects (Dou & Tang, 2009: 153, 165). They were the twin pillars of the booming Chinese economy and the main drivers of the soaring market demand for steel products, especially during and after the crisis.[330] The construction sector was China's biggest steel-consuming industry (Dou & Tang, 2009: 77; CCTV China Business Programme, 2009: 111). The Chinese economy's heavy reliance on investment in infrastructure construction and the housing market had developed into a deeply entrenched growth model. The robust growth and expansion of those steel-intensive downstream sectors were propping up China' growing demand for steel and iron ore over the 2000s. This was the

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as well as downstream logistic costs (such as transportation), sales and distribution channels.

[326] See: http://www.chinastock.com.cn/yhwz_about.do?methodCall=getDetailInfo&docId=3986392; http://www.ftchinese.com/story/001048463?full=y; http://finance.takungpao.com/hgjj/q/2014/0312/2347102.html; http://paper.people.com.cn/mszk/html/2013-12/23/content_1367275.htm

[327] See: http://www.miit.gov.cn/n11293472/n11293832/n11294132/n12858402/n12858492/14481313.html; http://www.21cbh.com/HTML/2012-1-6/wMMDcyXzM5MzcwMg.html; http://paper.people.com.cn/mszk/html/2013-12/23/content_1367275.htm

[328] Source: 'Surging Steel Capacity in the South' (June 18, 2013) http://www.ennweekly.com/2012/0618/5132.html

[329] Source: '2011 Steel Industry Operation Analysis and Projection for 2012' (February 29, 2012) http://www.miit.gov.cn/n11293472/n11293832/n11294132/n12858402/n12858492/14481313.html

[330] Interview: 47

fundamental cause for the unprecedented booming steel market and overheated steel industry (Dou & Tang, 2009: 4, 164-165).

Like China's other overheated sectors, the steel industry witnessed huge investment growth and output expansion over the decade of the 2000s when the Chinese economy was moving into top gear (Dou & Tang, 2009:1-2, 4, 165). As rising steel prices and considerable profit margins attracted huge investment into the steel sector (Dou & Tang, 2009: 114, 165, 167, 187, 189), there had been two rounds of rapid and aggressive expansion of the steelmaking industry: first in the 2003-2006 period and later in the post-2008 period, after the post-crisis stimulus rekindled investment in the steel industry and its downstream sectors.[331] Years of good earnings ensured that the steel mills' finances were sound; and that the steel mills had sufficient funds to engage in further expansion (Dou & Tang, 2009: 117). The business of producing low-end steel products (especially the construction steel) had no significant entry barriers in terms of steelmaking technology and capital requirements; as a result, a large number of small- and medium-sized private steel mills were able to enter the lucrative market in the early years (Dou & Tang, 2009: 77, 172, 189). The state-owned steel mills also had an 'intrinsic motivation' and enormous capacity for expanding and embarking on ambitious investment programmes (Dou & Tang, 2009: 114-115). Unlike their private counterparts, the state-owned steel mills enjoyed a number of advantages and privileges derived from their state-ownership: they were able to receive policy backing and funding support from the government, generally had easy access to bank loans and credit and land resources, and were also subject to soft budget constraint (Dou & Tang, 2009: 115, 128, 165-167, 187, 204). Hence, they had a strong tendency to pursue large-scale expansion and enlarge production capacity.[332] Under the dominance of the state-owned steel mills, the Chinese steel industry was thus prone to excessive investment (by the state-owned steel producers). And indeed, a significant proportion of investment in the sector came from the major large- and medium-sized state-owned enterprises (Dou & Tang, 2009: 114, 119-120).

Local protectionism was another major factor that aggravated overcapacity. The property and

[331] Interview: 47

[332] Private steel mills tended to be more cautious and more concerned with profit maximisation (Dou & Tang, 2009: 115, 128).

infrastructure construction sectors had become the pillar industries critical for GDP growth, governmental income (tax revenues and land rent) and employment. This was the case across the country. Local steel industries were of huge economic importance for the local economy and government in terms of creating jobs, propping up local GDP and providing a significant source of the government's revenue[333] (Dou & Tang, 2009: 190-191). Hence, local governments had every incentive to protect, support and promote the growth of their respective local steel industries. Local authorities could offer various preferential policies, tax concessions, subsidies and even government bailout;[334] they could even help local companies to find ways of circumventing the national industry policy and regulations,[335] or shutting their eyes altogether to problems or activities which contravened the national industry's requirements.[336] As a result, many small steel mills that had 'backward capacity' contrary to national requirements were allowed to remain in business, since they were of huge importance to the local economy. It was not unusual that local governments were found to be operating in collusion with the local steel mills or property developers to undercut the central government's efforts to curb excess investment in steel capacity or to cool the overheated housing market (Dou & Tang, 2009: 171-172).

Policymakers also faced the paradox whereby stringent rules about production capacity and technology requirements designed to eliminate excess and outdated capacity had in effect encouraged further expansion of steel capacity.[337] Many small- and medium-sized steel mills had engaged in further

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[333] See: http://finance.ifeng.com/a/20131101/10993579_0.shtml; http://finance.people.com.cn/stock/n/2013/0805/c67815-22441855.html; http://memo.cfisnet.com/2014/0718/1299550.html; http://www.modernweekly.com/business/content.aspx?artID=35701; http://finance.sina.com.cn/china/20140923/005920382341.shtml; http://www.guancha.cn/Business/2012_09_10_96553.shtml; http://finance.qq.com/a/20110824/002925.htm; http://www.sinotf.com/GB/Industry/1317/2012-11-26/1NMDAwMDEzMzE1NA.html; http://www.chinatimes.cc/pages/moreInfo1.htm?id=128600

[334] See: http://finance.ifeng.com/a/20131101/10993579_0.shtml; http://finance.sina.com.cn/china/20140923/005920382341.shtml; http://memo.cfisnet.com/2014/0718/1299550.html; http://www.steelsidc.org/newslist.asp?unid=3286&classid=4; http://blog.ifeng.com/article/19608955.html

[335] See: http://finance.sina.com.cn/china/20140923/005920382341.shtml; http://finance.qq.com/a/20110824/002925.htm; http://news.dichan.sina.com.cn/2012/09/05/559553.html

[336] See: http://finance.sina.com.cn/money/future/fmnews/20120813/073312829097.shtml; http://www.sinotf.com/GB/Industry/1317/2012-11-26/1NMDAwMDEzMzE1NA.html

[337] See: http://finance.people.com.cn/GB/1038/9270433.html; http://finance.qq.com/a/20110824/002925.htm; http://finance.sina.com.cn/money/future/fmnews/20120813/073312829097.shtml;

investment to expand and enhance their production capacity (for instance, by building bigger furnaces and more technologically advanced production equipments) lest they should be eliminated in the process under the new mandatory industry standards.[338] The smaller steel mills were by no means willing to withdraw from the market; the option to withdraw could be costly not least because of the huge sunk costs in the steel industry (Dou & Tang, 2009: 190). In fact, neither private nor state-owned steel producers could easily decide to withdraw and afford to incur the huge losses. For state-owned enterprises, an exit strategy was usually not a politically viable option because of the political pressure for job creation and preservation of the value of state-owned assets (Dou & Tang, 2009: 190-191). For many steel mills, the preferred strategy was to hold out as long as they could and to wait for the next wave of rising steel demand.[339]

http://www.custeel.com/shouye/common/viewArticle.jsp?articleID=3883626; http://finance.sina.com.cn/china/20140923/005920382341.shtml

338 See: http://www.chinatimes.cc/hxsb/special/7year/140718/1407182208-136549.html; http://www.zgjjxx.net.cn/2012_7/a24.htm; http://finance.sina.com.cn/chanjing/cyxw/20121017/140413395380.shtml; http://finance.qq.com/a/20110824/002925.htm

339 See: http://blog.ifeng.com/article/19608955.html; http://news.sina.com.cn/c/2008-12-01/073614810935s.shtml; http://www.21cbh.com/HTML/2012-1-6/wMMDcyXzM5MzcwMg.html

## 5.5 Conclusion

This chapter argues that the internal fragmentation plaguing the Chinese market actors in China's iron ore import sector and the structural problem of overcapacity facing the Chinese steel industry, constituted the two primary domestic factors that contributed to Chinese vulnerability in the resource politics vis-à-vis Australia.

Because of its internal fragmentation, the Chinese steel industry tried in vain to crackdown on rampant speculative trading in the iron ore spot market. Pluralisation of interests within the Chinese steel industry made it extremely difficult for industry leaders to organise unified actions against the foreign mining companies. In fact, the previous chapter already highlighted how internal fragmentation undermined the CISA's efforts to coordinate steel pricing and output policies amongst the major steel mills and the success of boycott actions during the benchmark price negotiation period. As illustrated in this chapter, the divergent agendas and inconsistent interest-orientations of the multiple market actors involved in iron ore importation, also undermined the industry leaders' joint efforts to combat iron ore speculation in the spot market. The conflicts between the steelmakers and resource traders, and the competitive dynamics between the state-owned major steel mills and China's numerous private small- and medium-sized steelmakers, combined to neutralise Chinese efforts to end speculative trading in the iron ore spot market. As a result, the growing speculative demand and surging spot market prices were allowed to seriously undermine Chinese negotiation efforts, aggravate Chinese vulnerability, and contribute to the rapid disintegration and eventual collapse of the traditional benchmark pricing regime (arguably to the detriment of the Chinese steel industry itself).

The persistent issue of overcapacity was one of the most pressing structural problems faced by the Chinese steel industry. As the experience of the Chinese steel industry demonstrated, excess investment in steel capacity considerably increased Chinese demand for iron ore, thereby contributing to the high prices of imported iron ore. Moreover, overcapacity led to over-supply of steel, which was a major cause for the steel industry's persistently bleak outlook over recent years, as the Chinese economy slowed down and demand for steel fell. Hence, the problem of overcapacity simultaneously aggravated Chinese vulnerability to iron ore price hikes and sensitivity to increased raw material costs. The problem of steel overcapacity was reinforced by a series of structural factors pertaining to China's economic growth model and development patterns; problems such as local protectionism and the Chinese economy's heavy reliance on property market and (infrastructure) investment, all combined to make it extremely difficult to combat overcapacity and eradicate its root causes without paying a huge price.

Complex interdependence theory also explains why the internal incoherence of the Chinese steel industry and iron ore import sector acted to reinforce Chinese vulnerability in the iron ore pricing struggle. From the perspective of complex interdependence theory, internal fragmentation in terms of pluralisation of interests and multiplicity of actors undermines the state's ability to manipulate asymmetrical interdependence. According to Keohane and Nye, 'states that are better placed to maintain their coherence… will be better able to manipulate uneven interdependence than fragmented states that at first glance seem to have more resources in an issue area' (Keohane & Nye, 2011: 29). Because of the pluralistic patterns of the actors involved and the divergent interests at stake, the Chinese industry actors remained rather incapable of maintaining their coherence in the collective struggle against the Australian mining companies. Notably, the divergent interests amongst the various state-owned and private market actors of the Chinese steel industry, as well as infighting between the steel industry actors and the minerals trading community, clearly demonstrated how internal fragmentation jeopardised Chinese attempts to curb rampant speculative trading and undermined some of the collective bargaining strategies used against the Australian mining oligarchs in the price negotiations.

# Chapter 6 Conclusion: Navigating between Power and Vulnerability

## 6.1 Introduction

This concluding chapter summarises the empirical findings in the thesis in relation to complex interdependence theory. Its purpose is to answer the research question by addressing the more specific research objectives that were set out in the introductory chapter.

This chapter argues that China does not enjoy a superior power position vis-à-vis Australia in bilateral resource politics under complex interdependence. Despite its perceived rising economic power, China has failed to gain the upper hand in the issue-specific power politics against Australia in the iron ore pricing war and in the controversy over Chinese resource investment. China sought to redress the unfavourable asymmetry in vulnerability interdependence, but so far its efforts have been seriously undermined by domestic constraints. Realist dynamics in the strategic dimension of the bilateral relations have also posed significant geopolitical constraints on the development of the resource ties. As China's strategic relations with Australia continue to be strained by the revived realist dynamics in response to China's rise, the development of China's resource ties with Australia faces growing strategic risks. Thus, despite the fact that China's overall power is growing rapidly, the country faces significant international political and domestic constraints; in order to protect her resource security interests, China has to navigate cautiously between exercising her rising power and paying heed to her vulnerability in relations with Australia.

## 6.2 China-Australia Relations Characterised by Complex Interdependence

Chinese-Australian relations are characterised by extensive economic interdependence. It is apparent that the military security agenda does not dominate China's relations with Australia, and inter-governmental links are by no means the only channels of contact between the two countries. Use of force is not a conceivable policy option for either Beijing or Canberra. Given these facts, Chinese-Australian relations can rightly be characterised as a situation of complex interdependence.

China's ties with Australia constitute multiple channels of contact. Transnational activities and institutions are growing between the two countries. Apart from the interstate relationship between the Chinese and Australian governments, a robust and growing transnational relationship has emerged that cuts across the business, societal and cultural domains. The exchange of tourists, students and other types of visitors constitute an important dimension of this transnational link; but the most important transnational actors come from the business and commercial sectors, who are engaged in a wide variety of economic activities. Thanks to the vibrant resource business environment, the transnational actors in resource-related businesses are the most powerful and prominent actors at the transnational level, be they Chinese or Australian.

There are both non-state actors and state-related actors involved in transnational dealings, not least in the vital transnational resource trade and investment. Transnational market actors from the resource-related industries play a major role not only in promoting trade and investment, but also in shaping national interests and government agendas in the bilateral dealings. Transnational multinational corporations constitute the most prominent actors in the resource-related transnational interdependence politics between China and Australia. On the Chinese side, at the forefront of the transnational struggle against the Australian mining oligarchs over iron ore pricing, are those market actors from the Chinese steel industry such as: the state-owned and private Chinese steel mills; hundreds of minerals trading companies; and powerful government-linked business associations such as the China Iron and Steel Industry Association and the China Chamber of Commerce of Metals Minerals and Chemicals Importers and Exporters. However, their respective interests and institutional allegiances seem to be highly fragmented and divergent to say the least. Amongst the Chinese investors entering or operating in

Australia's resource sector, are those government-related investment entities which constitute the majority of the Chinese investors and the main Chinese actors in the politics of bilateral investment relations. The internal fragmentation – which also occurs on the Australian side given the different interests of the Australian market actors from the mining sector and the divergent policy attitudes of political actors in the Australian polity on the questions of China and Chinese capital – demonstrates that states are not coherent units or the dominant actors in the resource politics and bilateral relations between China and Australia.

Having said that, beneath the transnational resource politics, tension and arm-twisting between the Chinese and Australian governments is in evidence. This interaction has arisen for a number of reasons. First of all, the majority of the Chinese market actors are state-owned entities representing the interests of the Chinese state (in addition to their own interests). Second, the Chinese foreign policy establishment, security apparatus, economic departments, and even the state's propaganda machine, have all become deeply entangled in China's resource politics vis-à-vis Australia, and played a role in developing China's policy response towards Australia. Certain powerful economic planning and regulatory agencies are the inherent stakeholders in the resource politics and are responsible for managing those so-called market actor-like interest groups; speaking out against the perceived Australian 'bullying' and 'discrimination' on behalf of the Chinese market actors from time to time; and devising China's state-centric mercantilist geo-economic strategies behind the scenes, not least those pertaining to overseas resource acquisition and commodity pricing politics. Third, a vast number of political and government actors from the Australian polity, ranging from the federal government (including at cabinet level) to the local governments, have got themselves involved in the transnational resource politics through their respective statutory roles in economic regulation and policy-making, most notably in the controversy over Chinese investment and Australia's foreign investment regime. In short, behind the transnational power struggle between the Chinese and Australian market actors (and government agents), are the sensitive and complicated political manoeuvres between the two governments. Nevertheless, that Chinese-Australian relations comprise multiple channels of contact with a prominent transnational link remains a valid point.

The bilateral relationship is not dominated by a military security agenda. The development of China's relationship with Australia has essentially been driven by trade and investment. China's interests which are at stake in the Australia ties are first and foremost derived from the country's domestic economic imperatives and resource requirements: Australia has abundant resources that China desperately needs. China's approach towards Australia is shaped first and foremost by the developmental imperative of resource security. A stable and reliable supply of resources has become and remains the most substantial policy imperative for the Chinese government and relevant industries. Australia's China policy is mainly driven by economic interests derived from the resource business. The two countries are essentially tied together through a complementary resource partnership that underpins the extensive economic interdependence between the two nations.

Although the bilateral (military) security relationship constitutes an integral dimension of the bilateral ties, China's bilateral ties with Australia contain no substantial military dimension. Despite mutual visits by military personnel at various levels and occasional naval port calls, there is a lack of meaningful defence cooperation; nor are there any direct military security threats that each poses to the other. Neither the PLA nor the Australian Defence Force has the intention or the capability to mount hostile attacks against the other country. According to You Ji, 'neither military has the desire to lift the bar of defence contacts beyond what can be qualificationted by their respective domestic politics or in light of the third party factor for some time to come' (Ji, 2013); and 'this is especially true in the case of Canberra, which may have prescribed Australia-China military ties only as a necessary supplement to a broader bilateral relationship that is beneficial to the Australian economy' (Ji, 2013).

Thus, it is not unreasonable to suggest that the military security agenda does not consistently dominate the policy agenda, especially since the beginning of this century. The overriding importance of the resource business has rendered the (traditional military) security dimension less prominent compared to past times. Given the prominence of the economic agenda, there is no longer a realist hierarchy of issues in the bilateral relations with the 'high politics' of military security dominating the 'low politics' of economic affairs.

Further, military force is not a viable option under the current strategic circumstances. For both countries, the direct use of military force against the other, or the threat of force, remains inconceivable as a cost-effective policy instrument for achieving security and economic objectives, or as a politically convenient means of wielding power in the bilateral relations. Although Australia's defence posture manoeuvres, in terms of troop redeployment and allied defence collaboration with America in recent years, are aimed at hedging against rising strategic risks of Chinese expansion, these actions do not constitute the direct use of military force (or threat of force) against China. Neither government is considering the use of military force a necessary or appropriate policy option to resolve their political differences or to obtain economic objectives in the bilateral context, at least for the time being. According to Chinese military officers, Australia poses no direct threat to China's national security and is outside the purview of the PLA research institutions, which mainly focus only on great power relations.[340]

During the post-9/11 period, competitive realist dynamics had largely receded. Given the general stability in the regional strategic environment and the good overall relations between China and the United States, Australia held a rather benign view of China's rise, and China-Australia relations experienced a period of entente. Since 2008, more adversarial dynamics re-emerged in China-Australia relations. In the face of the relative decline of the United States, China began to challenge U.S. strategic primacy and the regional security environment deteriorated rapidly as a result of China's changing strategic posture. Australia consequently hardened her strategic perception of China's rise and began to view China as a potential strategic enemy. The competitive dynamics between China and Australia were reinforced by a dramatic transformation of U.S.-Australia alliance, which was adapted in an attempt to contain Chinese expansionism.

However, the revival of realist dynamics has not fundamentally altered the liberal underpinnings of China's relations with Australia. Most of the above-mentioned characteristics of complex interdependence still remain despite the resurgence of realist signs in the strategic dimension of the bilateral ties. Indeed, high-level bilateral diplomacy between Chinese and Australia leaders since 2008 demonstrated that both counties were unwilling to let their political differences and strategic tensions jeopardise economic ties, particularly the critical resource partnership. Li Keqiang and Xi Jingping visited Australia in 2009 and 2010 respectively, and their visits were symbolic of Chinese commitment to the bilateral ties. During Julia Gillard's visit to China in 2011, both governments deliberately avoided sensitive

[340] Interviews: 18, 36

topics regarding China's strategic behaviour and the regional security situation, and instead focused the discussion on trade and investment. The delicate political manoeuvring behind the agenda setting suggested the predominance of pragmatism, as well as a willingness to protect and further develop economic relationships between China and Australia (Gao, 2012, 2013). What do all these factors mean in terms of complex interdependence theory? This will be elaborated in the following sections.

### 6.2.1 Position on Realist-Complex Interdependence Spectrum

The preceding paragraphs sought to establish the compatibility between the actual situation of the Sino-Australian relations and the defining theoretical tenets of complex interdependence theory, before applying the theory to the analysis of bilateral resource politics between China and Australia. This is because before further discussion on how the condition of complex interdependence shapes the dynamics of power politics in the Sino-Australian resource relationship, it is necessary to first validate the applicability of the notion of complex interdependence in capturing the basic conditions of the extensive economic interdependence between China and Australia. Along these lines, Keohane and Nye stress that:

> *It is important to determine the applicability of realism or of complex interdependence to each situation. Without this determination, further analysis is likely to be confused. Our purpose in developing an alternative to the realist description of world politics is to encourage a differentiated approach that distinguishes among dimensions and areas of world politics – not (as some modernist observers do) to replace one oversimplification with another.* (Keohane & Nye, 2011: 24)

In other words, it means that it is important to assess the degree to which the condition of complex interdependence is relevant to China-Australia relations. As Keohane and Nye have warned, 'Before one decides what explanatory model to apply to a situation or problem, one will need to understand the degree to which realist or complex interdependence assumptions correspond to the situation' (Keohane & Nye, 2011: 20). The preceding paragraphs have made a case for the general applicability of complex interdependence theory to this bilateral relationship by offering a broad sketch of the basic nature of

China-Australia economic interdependence.

Complex interdependence theory postulates a spectrum of world politics, whereby the typical situations of complex interdependence and realism are ideal types, and most situations will fall somewhere between those two extremes; one needs to understand the degree to which realist or complex interdependence assumptions correspond to the situation, or where that particular situation of world politics sits on the spectrum, before deciding which explanatory model to apply to a situation. Since the condition of extensive economic interdependence in China-Australia relations is largely consistent with the defining characteristics of complex interdependence, the situation of China-Australia relations corresponds to a position that is arguably very close to the 'complex interdependence' end of the spectrum. The revival of adversarial realist dynamics post-2008 in the strategic dimension of the bilateral relations has moved the bilateral politics towards the realist end of the spectrum to some extent. However, the overall position of Sino-Australian relations remains closer to the liberal (or complex interdependence) end of the spectrum.

### 6.2.2 Breakdown of Linkage Process and Relevance of Issue-Structure Model

One immediate implications of this spectrum position for the resource power politics between China and Australia is the breakdown of linkage processes and the applicability of the issue-structure model for the analysis of Sino-Australian resource politics. According to Keohane and Nye, the relationship between the overall power balance between two countries and the pattern of outcomes of specific issue areas depends on whether the linkage processes are working. Under complex interdependence, linkage by strong states will be more difficult to achieve since military force will be ineffective and too costly, and the military security agenda no longer dominates (Keohane & Nye, 2011: 15); the stronger power is unable to translate its overall power advantage (in military terms) into issue-specific power advantage to gain a desirable outcome. As a result, the issue-specific power structure model becomes a more relevant explanatory tool for analysing power politics of interdependence in non-military economic issues as the distribution of power within each issue becomes more important in determining the outcome (Keohane & Nye, 2011: 42-44).

Developments in China-Australia resource politics take place against the general background of China's rise in international significance. Whether China's growing power or overall power advantage vis-à-vis Australia can help China enhance her power position vis-à-vis Australia in the specific issues of iron ore pricing and resource investment, would depend on the nature of the linkage mechanism. If the linkage mechanism functions, it would enable China to translate her overall power advantage into issue-specific power advantage in bilateral resource politics. Otherwise, China's growing overall power would not help improve her power position (or bargaining position) vis-à-vis Australia in those specific issue areas. Given the 'spectrum position' of China-Australia relations, the issue structure model of power analysis is more applicable than the (overall power) structure model in the study of power politics of resource interdependence between the two countries.

### 6.2.3 Issue-specific Power Derived from Asymmetrical Vulnerability Interdependence

The issue-specific power relationship reflects the underlying patterns of sensitivity and vulnerability interdependence between the two sides in a specific issue. Given the negligible role of force and the military security agenda, states will rely more on other instruments in order to wield power. Since asymmetrical interdependence can be a source of power, states will manipulate asymmetrical interdependence as a policy instrument in the power politics of economic interdependence. From a strategic point of view, less vulnerable states will try to use asymmetrical interdependence in particular groups of issues as a source of power. Hence, manipulation of asymmetrical sensitivity and vulnerability interdependence specific to issue areas becomes an instrument of state policy (Keohane & Nye, 2011: 13-15).

This pattern is observed in the political struggles over the iron ore pricing and Chinese resource investment issues. Resource power politics between China and Australia took place at the sensitivity and vulnerability levels. Outcomes of power politics over the specific iron ore pricing and resource investment issues were determined by the distribution of power derived from asymmetrical sensitivity and vulnerability interdependence. In other words, the key to understanding the power dynamics behind the iron ore pricing and resource investment issues, is the issue-specific power structure analysis that looks specifically at the patterns of sensitivity and vulnerability interdependence between China and Australia.

### 6.2.4 Struggle for the Upper Hand: Chinese Vulnerability and Australian Dominance

The Chinese steel industry was extremely vulnerable to iron ore price rises. The Australian mining giants were able to manipulate the asymmetrical vulnerability interdependence to maximise their gains from the iron ore trade without having to worry about Chinese retaliation. There was no alternative other than to accept the price increase imposed by the mining companies; in other words, the costs of making any effective adjustments to enable the use of a viable alternative would be too high under the existing market situation and policy framework.

The Chinese steel industry attempted in vain to boycott Australian iron ores from Rio Tinto and BHP Billiton. As it turned out, the Chinese steel industry could not sustain any long period of boycott action because Chinese steel mills could not allow production and operation to be seriously disrupted. In this regard, the Chinese steel industry also lost the battle at the sensitivity level. More importantly, the Chinese action was a misguided attempt to manipulate asymmetrical sensitivity interdependence. The Chinese presumed the Australian mining companies would be sensitive to the impact of the Chinese boycott action; but they had failed to consider the underlying pattern of asymmetrical vulnerability, which was in the mining companies' favour. As Keohane and Nye point out, vulnerability interdependence is the more important political aspect of mutual dependence than sensitivity interdependence as a form of power: '… coherent strategies must be based on the underlying patterns of vulnerability interdependence'; otherwise, 'an attempt to manipulate asymmetrical sensitivity interdependence without regard for underlying patterns of vulnerability is likely to fail' (Keohane & Nye, 2011: 14).

Similarly, when the Chinese negotiators proposed the 'Chinese model' for the benchmark price negotiation, their proposal could only end in failure because the Chinese paid scant attention, or had seriously misjudged, the actual power relationship defined by the pattern of asymmetrical vulnerability between the Chinese steelmakers and the Australian (and Brazilian) mining giants.

Having realised their vulnerable position vis-à-vis the Australian mining companies in the pricing struggle, the Chinese actors began to take actions to reduce their vulnerability. The idea was to seek greater Chinese control of upstream resources and to reduce Chinese dependence on the three mining oligarchs. A major measure was to increase Chinese captive mines abroad by overseas investment and acquisition, which would presumably help increase Chinese market influence over resources, including the critical pricing power over major commodities such as iron ore.

Australia's resources sector had become a major destination for Chinese resource investment in this context. The Australian resource companies became weakened financially under the impact of the global financial and economic crises, and were therefore vulnerable to Chinese capital. As such, they could easily fall prey to Chinese government investors supported by the Chinese state with easy credit and political backing. The surge in Chinese government-related investment since 2008 constituted a scramble for Australia's resource assets and, therefore, posed a serious threat to Australian control over her resources. In other words, the influx of Chinese government investment, if unchecked, would seriously undermine Australia's dominant position in the resource politics.

In this regard, the Australians were highly sensitive to China's state-driven strategic manoeuvres to buy up Australia's major resource assets. In the face of this unfavourable pattern of sensitivity asymmetry, the Australian government therefore responded by intervening and tightening the foreign investment regime against the Chinese government-related investment. This was essentially an attempt on the part of the Australian authorities to change the rules of the game for resource politics in the investment arena. If the Australian foreign investment regime chose not to discriminate against Chinese government investment, the Australian mining industry and resource businesses would become seriously disadvantaged in their contest with Chinese government-related investors.

The initial power advantage enjoyed by the Chinese government investors was inherently unstable, since the Australian authorities, as the host government, were stronger in the vulnerability dimension. The Chinese investors were vulnerable to Australian government intervention and policy shifts designed to discriminate against the government background and the strategic pattern of Chinese resource investment. This was partly because there were few private Chinese companies that were able to carry out substantial foreign direct investment in the capital-intensive resource acquisition projects abroad without state support. Moreover, the decision to discriminate against foreign government-related investment entities was a sovereign right of the host government, and the Chinese investors had no option but to adjust their investment behaviour and adapt their investment strategy to the new regime, however unwelcome the changes might have been.

By transforming the rules of the game, the Australian government sought to preserve Australia's resource interests. The exercise of Australia's sovereign power to limit inflows of Chinese capital was aimed at forestalling strategic Chinese attempts to change the underlying pattern of vulnerability asymmetry in the bilateral resource politics. As a result, the Chinese government and state-owned investment entities appeared disadvantaged in terms of asymmetrical vulnerability interdependence in the power politics of foreign investment. In short, the Chinese attempt to take advantage of its superior position (derived from state support) on the sensitivity dimension ended in disaster because of a failure to recognise Chinese weakness at the vulnerability level.

## 6.3 Agenda Formation: Sensitivity, Economic Processes and Pluralisation of Interests and Actors

Under complex independence, 'high politics' in terms of military security can no longer dominate state-level politics; and agenda politics is no longer primarily influenced by balance of power considerations and perceived military security threats. Rather, agendas can be heavily influenced by pluralisation of interests among different actors and domestic economic processes. This is evident in China's resource power politics vis-à-vis Australia, whereby a variety of Chinese actors are involved in the process of agenda formation.

In the case of iron ore pricing politics, the politicisation of iron ore prices in the Chinese policy discourse was a result of rising Chinese sensitivity to surging iron ore prices over the years. The issue was created by China's economic growth and growing demand for resources, as well as the agitation for Chinese pricing power. The subsequent politicisation and even securitisation of the iron ore issue were closely related to the declining earnings performance of the entire Chinese steel industry since the end of the 2000s, which had considerably increased the Chinese steel industry's sensitivity to surging raw material costs.

The formation of an agenda on iron ore pricing also reflected the will of the discontented Chinese steel mills, especially those large state-owned enterprises which had become upset enough to raise the issue and demand government intervention following consecutive defeats in the price struggles versus the Australian mining companies. Moreover, China's rising market status in the global iron ore trade and the perceived shifts in the distribution of power (in terms of asymmetrical interdependence) on the issue also increased Chinese expectations and fuelled Chinese dissatisfaction, thereby facilitating the emergence of the iron ore pricing agenda.

Both the Chinese steelmakers and Australian mining companies had growing complaints about what they all perceived as an increasingly ineffective iron ore pricing regime: the Chinese believed that the system was being abused by the dominant mining giants and no longer protected Chinese interests and demanded modification on their own terms; while the Australians preferred its wholesale replacement by a completely new pricing arrangement, as they believed that the existing pricing mechanism could no longer maximise their interests in the iron ore trade. Hence, both the Chinese and Australians became impatient with the existing benchmark pricing regime as they believed that the mechanism could no longer deliver outcomes consistent with the underlying power structure, although the Chinese had most clearly misjudged the situation.

Arguably, the iron ore pricing agenda was mainly promoted by the state-owned sector of the Chinese steel industry. State-owned industrial capital had a monopoly on access to imported long-term contract ores, which were considerably cheaper than spot market ores when demand for iron ore was high. To a large extent, the problem of rising benchmark prices had no immediate relevance to China's numerous small- and medium- private steel mills, which always had to buy the more expensive ores from the spot market regardless of the benchmark prices of the long-term contract ores. Hence, the politicisation of the iron ore price issue mainly reflected the interests of the large state-owned steel mills that had privileged access to long-term contract ores.

Some of these political dynamics were also found in the formation of the agenda related to the Chinese investment and acquisition of Australian resource assets. In the face of a sudden influx of Chinese government-related investment in the Australian resource sector, the Australian government became increasingly sensitive to the aggressive Chinese investment and acquisition spree and its market implications. The existing Australian mining oligarchs, who preferred the status quo in market conditions, viewed the infiltration of Chinese capital with hostility and actively lobbyied the government against Chinese investment. The politicisation of the Chinese investment issue in Australia was also a result of the fact that the previous Australian foreign investment regime had come to be seen as ineffective in protecting Australian economic and security interests in the face of the Chinese scramble for Australian resource assets.

On the Chinese side, government investors had huge misgivings about Australian discrimination. Those state-owned industry and multinational corporations from the Chinese metallurgical industries and other resource-related sectors were powerful interest groups seeking to push investment access and discrimination issues onto interstate agenda. Developments in Australia showed that many of the Chinese transnational market actors pursued their own goals in terms of international expansion and asset acquisition, often under the guise of Chinese national interests and state resource strategy. In no small measure, the interests of those Chinese corporations and industries played a dominant role in shaping China's policy agenda towards Australia, even if the ultimate expression of those industry and business interests might impinge on China's political ties with Australia. China's rise and Australia's growing economic dependence on China, also provided the Chinese with a sense of empowerment that had in one way or another encouraged the Chinese government to pursue its investment agenda forcefully by exerting huge pressure on the Australian policymakers.

## 6.4 Domestic Sources: Economic Constraints and Internal Fragmentation

The sources of Chinese vulnerability in the power struggles over iron ore pricing and resource investment, also demonstrate how domestic constraints could complicate efforts to manipulate asymmetrical interdependence under complex interdependence conditions. Amongst other problems, internal fragmentation between the Chinese actors and the structural problem of overcapacity in the Chinese steel industry constituted two major domestic factors that contributed to Chinese vulnerability in the resource politics vis-à-vis Australia.

The divergent interests and lack of internal coherence amongst the Chinese actors demonstrated typical problems under complex interdependence. According to Keohane and Nye, internal fragmentation, in terms of pluralisation of interests and actors, undermines the state's ability to manipulate asymmetrical interdependence; 'states that are better placed to maintain their coherence will be better able to manipulate uneven interdependence, than fragmented states that at first glance seem to have more resources in an issue area' (Keohane & Nye, 2011: 29). This is most evidently demonstrated in China's resource power politics with Australia, most notably in the intense struggle over iron ore pricing. The Chinese side appeared to have been seriously disadvantaged by these complications. Despite the perceived growing improvement in the Chinese power position following China's enhanced market status and financial prowess in the two specific issues concerning resource investment and iron ore pricing, the Chinese actors remained near incapable of maintaining their coherence and manipulating the uneven interdependence to their own advantage. In this sense, internal fragmentation was a crucial source of Chinese vulnerability in the bilateral resource politics vis-à-vis Australia.

Internal fragmentation within the Chinese iron ore import sector had seriously undermined collective efforts in the price negotiations, because it jeopardised Chinese attempts to end iron ore speculative trading, which was a major culprit in the crisis of surging iron ore prices. Iron ore speculation not only pushed up spot market ore prices, but also propped up benchmark prices and undermined Chinese negotiation efforts against the Australian mining companies. However, the divergent interests and infighting between China's (state-owned) steel industry and the minerals import and export trading community, as well as the conflicts between the CISA and the CCCMC, largely crippled the CISA-led efforts to crack down on iron ore speculation and further weakened the Chinese bargaining position. Moreover, the ‘selfish’ agenda of the large state-owned steel mills and the CISA also weakened the Chinese commitment to end speculation, which was in effect a good way of making huge profits at the expense of China’s numerous small- and medium-sized private steelmakers, to whom scant regard was given.

During price negotiations, internal fragmentation within the Chinese steel sector also reinforced Chinese vulnerability at the negotiation table. Some leading steel mills were keen to pass on the expected rising raw material costs to downstream buyers, by raising steel prices before the settlement of benchmark prices. This occurred even though such pre-emptive acts of steel pricing would seriously jeopardise the ongoing negotiation efforts and were strongly opposed by the industry leader (the CISA). This problem was aggravated by the existence of numerous Chinese steel mills, which had allowed the mining companies to play the game of ‘divide and rule’ to defeat the Chinese steel industry. When the negotiations reached a deadlock and the CISA organised a collective boycott to exert pressure on the mining companies, many Chinese steel mills were willing to undercut the industry efforts and ‘defect’ to the mining companies’ side. The fact that many Chinese steel mills were willing to trade the industry’s commercial secrets for cheap long-term contract ores also illustrated the devastating impact of internal fragmentation.

To some extent, internal fragmentation and incoherence also reinforced Chinese vulnerability in the investment issue. The Chinese transnational investors in Australia were mainly large state-owned enterprises from the mining and metallurgical industries. They played the dominant role in implementing the state-sponsored national geo-economic strategy of resource acquisition. Nonetheless, the investment strategies of those transnational actors were also driven by their own corporate agendas. Despite their government background, these state-related market actors were keen to pursue their own goals under the guise of national interest. In other words, they had a huge incentive to seek to enhance their own corporate profiles, expand their global business, and acquire the best resource assets with the help of state capital. In spite of the perception of a monolithic ‘China Inc.’, the lack of coordination and even internal competition amongst Chinese SOE investors as seen in Australia, undermined China’s resource acquisition strategy and compromised the chances of some major investment deals of strategic significance. Some of the unhelpful candid remarks made by Chinese officials and industry leaders also fuelled Australian suspicion and fear about ‘China Inc.’ and Chinese intentions, thereby contributing to Chinese investors’ vulnerability.

The other major source of domestic constraint was the persistent problem of overcapacity in the Chinese steel industry; indeed, it was the most pressing structural problem faced by the Chinese steel industry. Excess investment in steel capacity considerably aggravated the Chinese predicament in the iron ore struggle by propping up Chinese demand for imported iron ores, thereby contributing to their high price, and depressing steelmakers’ profit margins. Moreover, overcapacity led to over-supply of steel; this was a major cause for the steel industry’s persistently bleak outlook over recent years as the Chinese economy slowed down and demand for steel fell. Thus, the problem of overcapacity simultaneously aggravated Chinese vulnerability to iron ore price hikes and sensitivity to rising raw material costs. This problem was reinforced by a series of structural factors pertaining to China’s economic growth model and development patterns. Problems such as local protectionism and the Chinese economy’s heavy reliance on property market and infrastructure investment, all made it extremely difficult to combat overcapacity and eradicate its root causes without paying a huge price.

## 6.5 Political Constraints of Realist Dynamics on China's Resource Ties with Australia

Although the condition of complex interdependence was useful in terms of understanding the issue-specific power dynamics of resource politics, one has to go beyond the specific issues and look at the broader political context in which the bilateral resource politics have evolved. From the realist-complex interdependence spectrum perspective, the position of China-Australia relations was closer towards the liberal end than the realist end. In other words, China's relations with Australia do not represent an ideal-type condition on the extreme end of complex interdependence; however, there is still an important realist dimension to consider when analysing resource politics between China and Australia. Moreover, the post-2008 strategic dynamics between the two countries resembles intensified realist dynamics; from a theoretical point of view, there has been a steady shift towards the realist end along the spectrum since 2008. Since the character of any particular situation of world politics depends on its position on the spectrum, this realist dimension and its implications must be taken into consideration, not to mention the fact that its relative salience in the bilateral politics has been increasing since 2008.

The implications of the realist dynamics for the bilateral relationship are profound. China remains an authoritarian rising great power under Communist rule. Australia is a Western democratic ally of the United States located in the Western Pacific. China and Australia are not allies, but potential strategic adversaries with opposing political institutions and ideologies and divergent strategic outlooks. Thus, the strategic ties between China and Australia have always been extremely delicate and set the limit for the development of the overall political relationship. The adversarial realist dynamics were held in check during the post-9/11 era as the two countries experienced a period of entente; but the development of the bilateral political relationship during the post-9/11 period was still constrained by the fundamental political differences and strategic disagreements, as seen by Australia's rejection of Chinese proposal for a Sino-Australian 'strategic partnership' in the mid-2000s. The revived realist dynamics since 2008 have arguably reinforced their political differences and exposed underlying adversarial dynamics in the strategic dimension of the bilateral ties, in response to the deteriorating regional security situation and intensified China-U.S. strategic rivalry.

### 6.5.1 Limits of the Bilateral Resource Ties

Since the resource relationship has grown out of such a delicate political relationship, the realist strategic dynamics always have a constraining effect on the development of the resource partnership. The political controversies over Chinese investment and iron ore trade were suggestive of the extent to which the resource ties have grown and were able to develop under such a difficult political framework. Despite the substantial trade relationship, investment ties between China and Australia were significantly more limited.

China's resource-related investment in Australia was deliberately restricted and controlled by the Australian government. This was largely due to the disincentives to Chinese investment erected at the Australian end (Laurenceson, 2013). The Australian government required all foreign government-related investment proposals, irrespective of size, to go through a FIRB approvals process to determine whether they were in the national interest. In contrast, inward foreign investment by private firms only required FIRB approval if the amount was more than AU$248 million, and in the case of U.S. and New Zealand firms, the threshold was raised further to AU$1.08 billion. What these rules mean in practice is that nearly all Chinese inward investment must go through a lengthy and uncertain approval process, while only a fraction of investment from other countries must do the same (Laurenceson, 2013).

Studies show that Chinese investment in Australia has indeed remained marginal. The stock of Chinese investment in Australia has stayed low, particularly compared with the stock of U.S. investment. In fact, Australia's utilisation of China's vast pool of domestic savings has been limited. At the end of 2012, accumulated stock of U.S. investment stood at AU$617.6 billion, whereas the stock of Chinese investment totalled only AU$22.9 billion, which was a mere 1.1 percent of the total stock of foreign investment in Australia (Laurenceson, 2013). From 2003 to 2012, there have been AU$330 billion net inflows of U.S. investment into Australia; by contrast, there has only been AU$20 billion net inflow of Chinese investment during the same period (Laurenceson, 2013). In 2012, net inflows of Chinese investment amounted to AU$3.9 billion, not much higher than the average annual value since 2006, and well down on the high of AU$7.8 billion in 2009; net inflows of U.S. investment in 2012, however, totalled AU$43.7 billion; even if only direct investment is considered, as opposed to including portfolio investment, net inflows from the United States were still four times higher than those from China. This data suggests that China has hardly become a more important supplier of capital to Australia over the years (Laurenceson, 2013).

The correlation between investment ties and strategic relationship was perhaps most convincingly put by the Australian Ambassador to the United States, Kim Beazley. In early 2014, he delivered a stark wake-up to Australian politicians and business people who believed that Australia enjoyed a 'special' relationship with China: 'Some people in Australia think we are more engaged with China than the Americans. I am afraid to say that is ludicrous. We are not on the same chessboard'.[341] According to Beazley, Australia had invested US$430 billion in the United States, which was about 20 times what it directed to China; and America had more than US$650 billion in Australia, which was 10 times what it had in China. Beazley warned about placing too much confidence in bilateral China-Australia trade as a diplomatic tool. Although trade was essential, it was 'ephemeral' because the relationship was at the mercy of supply and demand; investment in each country was more strategically important because 'it has a greater level of permanency'.[342]

The tightening of regulatory scrutiny on Chinese investment took place against the backdrop of rising anti-China feeling across the Australian polity and mainstream political spectrum. There was a pervasive perception that given its unlimited appetite for mineral resources China was seeking to buy up Australia's resource assets and control the country's mining industry. Australia's public opinion has, in general, turned against China and Chinese investment in recent years. Australian anxiety over the resource investment relationship with China was vividly captured by Paul Kelly, whose warning was indicative of Australian unwillingness to forge a genuinely close and even symbiotic economic relationship through investment. Calling the Chinese investment issue a 'manageable minefield', the Editor-At-Large of *The Australian*, warned that:

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[341] See: http://www.theaustralian.com.au/business/economics/beazley-tells-us-to-get-real-on-aussie-trade/story-e6frg926-1226812467174#; https://au.news.yahoo.com/thewest/a/21499579/australias-special-china-ties-a-delusion/

[342] Ibid.

> *China's rise will mean for the first time in Australia's history that our dominant trade partner will not be a strategic ally of the West; for the first time the overseeing authority of our partner will be the Communist Party; for the first time the values of our partner will be radically different from Australia's…It is precisely the differences between Australia and China that generate the unpredictability.* (Kelly December 16, 2009)

The bilateral trade relationship has become much more developed thanks to the vital iron ore business. However, this robust trade relationship in no measure reflects a genuinely equitable and fair partnership. Australia's mineral suppliers' main interested has been in taking advantage of Chinese vulnerability for short-term profit maximisation. They have shown scant regard for Chinese misgivings about this exploitative trade relationship. Indeed, this pattern of trade has been reflective of the broader Australian approach to bilateral ties with China. In the words of the Australian ambassadors to China, the Australians tend to view the relationship with China primarily in 'transactional' terms (Raby, 2013). Whilst ruthlessly pursuing profit maximisation in iron ore trade, the Australian miners had no concerns about the legitimate interests of the downstream Chinese buyers in terms of survival and development needs. Australian society has remained by and large ignorant of the plight of the Chinese steel industry and its internal conflicts. With scant regard for Chinese interests and concerns, the Australian government has remained protective of the mining interests in the iron ore trade under the banner of 'normal commercial relations' (Leaver, 2010). In fact, the Labour government itself was keen to join the iron ore feast by proposing the resource super profits tax scheme, which would only further increase the Australian government's revenue at the expense of downstream Chinese ore buyers and reduce the miners' shares of the profits from the lucrative iron ore business. Although the proposed scheme was eventually defeated by Australia's powerful mining interests and cost Kevin Rudd his Prime Ministership, the event was indicative of the Australia's transactional, opportunistic if not bullying approach to its resource trade ties.

Arguably, the Chinese abandoned their initial fantasy of forging an intimate strategic resource partnership with the Australians. A deep sense of mistrust, betrayal and frustration characterised the Chinese reaction to the failure of a number of high-profile Chinese investment bids, most notably by the collapse of the Chinalco-Rio deal. The Chinese felt betrayed and deeply hurt when Rio Tinto chose to break away from the agreed strategic partnership with Chinalco, and instead formed an iron ore alliance with its competitor BHP Billiton to strengthen the producer coalition at the expense of the Chinese customers[343] (Cai July 10, 2009). China's ensuing anger and frustration dealt a heavy blow to the already fragile investment relationship. Many Chinese consequently came to believe that Rio Tinto (and also the Australian government) was being dishonest and ungrateful: China wanted to embrace Rio Tinto as a long-term strategic partner and had helped Rio weather the storm through the most difficult time of the crisis; instead, Rio chose to break faith with the Chinese and showed itself to be nothing but a calculating and ruthless partner that had exploited the good faith of the Chinese.[344] As a result, China was said to have lost faith in Rio, which was no longer regarded as a trustworthy partner with whom China could build a reliable strategic partnership. The Chinese believed that their failed partnership with Rio had taught them a lesson to not be too trusting: they would no longer look for ways of nurturing any special investment relationship with the Australians. Instead, the Chinese would pick up this Australian-style business expediency very quickly, which they thought in the long run would eventually cause Australia grief when the resource boom and the era of the seller's market comes to an end.[345]

Indeed, Chinese investors were prepared to invest elsewhere if political risks in Australia were to become unbearable. Some Australians had already taken note of the profound shift in the latest Chinese investment attitude towards Australia and warned that the situation on the ground was alarmingly discouraging, as Chinese investors had begun to vote with their wallets by investing elsewhere (and even leaving Australia), whilst big Chinese investments no longer went to Australia (Garnaut February 21, 2009; May 31, 2011). During the official visit of Politburo Standing Committee member Jia Qinglin to Australia in April 2011, a senior Chinese official from the General Office of the CPC (Communist Party of China) Central Committee accompanying the visiting Chinese delegation left a private note to the effect that China would divest itself of its assets in Australia and even reconsider its approach to trade relations

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[343] Interviews: 7, 70

[344] See: http://www.chinaweekly.cn/bencandy.php?fid=63&aid=4310&page=5;
http://www.cnstock.com/paper_new/html/2009-06/10/content_70958934.htm;
http://www.wccdaily.com.cn/epaper/hxdsb/html/2009-06/11/content_65129.htm;
http://www.e-economic.com/html/Comments/pl/20090610/12808112.html;
http://views.ce.cn/view/economy/200906/06/t20090606_19257347.shtml;
http://www.chinaelections.com/article/757/149973.html

[345] Interview: 7

with Australia, if Canberra continued to side with Washington against Beijing and ignore China's interests; that Australians would be ill-advised to take the strong economic relationships with China for granted.[346]

### 6.5.2 Reliable Resource Partnership with A Potential Strategic Adversary?

China had great expectations for its resource ties with Australia during the post-9/11 era. When the bilateral relationship was in its best shape around the mid-2000s, Beijing wished to forge a long-term strategic resource partnership with Australia, and hoped the close resource partnership would help promote and develop the bilateral political relationship with Australia into an exemplary role model for Sino-Western relations.[347] When the Labour Party came to power, the market opportunities created by the outbreak of the global financial crisis led to a rapid expansion of Chinese resource ambitions and a scramble for Australian resource assets through overseas investment. Australia's strong reaction against Chinese investment came as a big surprise to the Chinese.[348] China subsequently began to have growing doubts about the reliability of the resource partnership with Australia as the bilateral strategic relationship deteriorated. Reliability of resource supply had thus become a major policy concern for China.

The rise of the resource security agenda added significance to the security relationship with Australia. The bilateral security relationship itself was not of major significance in China's foreign policy thinking, given Australia's relatively limited strategic weight as well as geographical distance from China. However, the importance of the resource agenda reinforced China's strategic anxiety over Australia's security orientation. In other words, resource security concerns reinforced China's traditional security concerns about Australia's strategic posture. This was why the resource ties helped Australia to punch above its weight vis-à-vis China and endow the country a level of influence well beyond its size in terms of population and geo-strategic importance[349] (Yu & Xiong, 2012).

[346] Interview: 56

[347] Interviews: 27, 44

[348] Interview: 44

[349] Interview: 24

Much has been said about the strategic dilemma faced by Australia in its ties with China. For Australia, China had become a potential strategic adversary whilst at the same time becoming Australia's major economic partner. However, China was also in an acute dilemma in which her critical resource supplier had become a potential strategic adversary. The stronger the realist dynamics in the bilateral relations became, the more acute the dilemma. Both countries needed each other for economic reasons, but both had begun to treat the growing resource ties with increasing caution and wariness. In an event of major conflicts between China and the United States, Australia would likely be drawn into a conflict against China. In such a scenario, China's resource interests in Australia would be greatly endangered: Chinese resource assets might be seized by the Australian government; critical sea lanes of communication along the Indian Ocean might be taken by the allied forces; and the critical minerals and energy resources trade might come to an end if Australia imposed trade sanctions against China. These nightmare scenarios embody some of the potential strategic threats to China's resource security, in the event that strategic tensions with the United States and other regional powers escalate into a great power war. In theoretical terms, Chinese-Australian relations could be characterised primarily by realist conditions under such circumstances, far closer to the realist end of the spectrum of world politics.

In policy terms, there is a strong imperative to stabilise the security relationship with Australia and keep the realist dynamics in check. For this reason, China has a huge incentive to tap into the strategic dividend of the growing economic interdependence deriving from the resource ties. The rapid development of China's resource ties with Australia in the post-9/11 period were not so much a result of the conscious implementation of Chinese economic statecraft as a consequence of China's domestic economic development;[350] but rather the strategic dividend derived from the economic ties had been apparent during that period as China's economic rise helped to stabilise political relations with Australia. In the post-2008 era, China arguably faced a more difficult strategic environment for the practice of economic statecraft with regional countries such as Australia. If the strategic tension in Chinese-Australian relations and China-U.S. relations continued to grow, it could become more difficult for both China and Australia to adopt a 'de-coupling' strategy to separate their economic and strategic agendas in bilateral dealings. Yet, the need for effective economic statecraft to stabilise the security

[350] Interview: 16

relationship with Australia will become ever more imperative for the sake of ensuring a reliable resource supply from Australia. China might expect Australia to maintain its neutrality in an event of major regional strategic contingency issue involving China; but given the strategic reality, the best long-term option for China would be to avoid becoming over-dependent on Australia for its resource supply.

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# Appendix: Full List of Interviews

**Trip 1: China (Shanghai), July-August 2009**

| No. | Name | Position | Organisation |
|---|---|---|---|
| 1 | Anonymous | Professor and Senior Fellow | 上海国际问题研究院亚太研究中心<br>Center for Asia-Pacific Studies, Shanghai Institutes for International Studies (SIIS) |
| 2 | Anonymous | Associate Professor | 上海社会科学院世界经济研究所全球化经济研究室<br>Section of Globalised Economic, Institute of World Economy, Shanghai Academy of Social Sciences (SASS) |
| 3 | Anonymous | Professor | 上海社会科学院国际战略研究中心<br>Center of International Strategic Studies; Institute of Asia and the Pacific, SASS |
| 4 | Anonymous | Professor | 华东师范大学澳大利亚研究中心<br>Australian Studies Centre, East China Normal University |
| 5 | Anonymous | Associate Professor | 复旦大学国际关系与公共事务学院国际政治系<br>Department of International Politics, School of International Relations and Public Affairs, Fudan University |

**Trip 2: China (Beijing and Shanghai), December 2009 – January 2010**

| No. | Name | Position | Organisation |
|---|---|---|---|
| 6 | Anonymous | Senior Research Fellow | 中国国际问题研究所亚太安全与合作研究部<br>Department of Asia-Pacific Security and Cooperation, China Institute of International Studies (CIIS) |
| 7 | Anonymous | Professor and Research Fellow | 中国社会科学院亚洲太平洋研究所<br>Institute of Asia-Pacific Studies, Chinese Academy of Social Sciences (CASS) |
| 8 | Anonymous | Associate Professor and Associate Research Fellow | 中国社会科学院亚洲太平洋研究所经济研究室<br>Department of Economic Studies, Institute |

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| | | | of Asia-Pacific Studies, CASS |
| 9 | Anonymous | Professor | 北京大学国际关系学院<br>School of International Studies, Peking University |
| 10 | Anonymous | Professor | 北京大学国际政治经济研究中心<br>Center for International Political Economy, Peking University |
| 11 | Anonymous | Professor | 北京大学国际战略研究中心<br>Center for International & Strategic Studies, Peking University |
| 12 | Anonymous | Associate Professor | 北京大学国际战略研究中心<br>Center for International & Strategic Studies, Peking University |
| 13 | Anonymous | Professor | 北京大学国际战略研究中心<br>Center for International & Strategic Studies, Peking University |
| 14 | Anonymous | Professor | 北京大学国际关系学院<br>School of International Studies, Peking University |
| 15 | Anonymous | Professor | 北京大学国际关系学院<br>School of International Studies, Peking University |
| 16 | Anonymous | Professor | 外交学院战略与冲突管理研究中心<br>Center for Strategic and Conflict Management, China Foreign Affairs University |
| 17 | Anonymous | Associate Professor | 清华大学国际关系学系<br>Department of International Relations, Tsinghua University |
| 18 | Anonymous | Researcher | 中国人民解放军国防大学<br>Chinese People's Liberation Army National Defence University |
| 19 | Anonymous | Associate Professor | 中国现代国际关系研究院亚非研究所<br>Institute of Asian and African Studies, China Institutes of Contemporary International Relations (CICIR) |
| 20 | Anonymous | Associate Research Fellow | 中国青少年研究中心<br>China Institute for Youth and Children |

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**Trip 3: China (Beijing, Shanghai & Hangzhou), October-December 2010**

| No. | Name | Position | Organisation |
|---|---|---|---|
| 21 | Anonymous | Professor | China Research Centre, the University of Technology Sydney (based in Beijing) |
| 22 | Anonymous | Journalist | Australian Broadcasting Corporation (ABC) |
| 23 | Anonymous | Journalist | The Sydney Morning Herald and The Age |
| 24 | Anonymous | Senior diplomat | Australian Embassy, China |
| 25 | Anonymous | Senior diplomat | Australian Embassy, China |
| 26 | Anonymous | Senior diplomat | Australian Embassy, China |
| 27 | Anonymous | Researcher | 中国现代国际关系研究院南亚东南亚及大洋洲研究所<br>Institute of South & Southeast Asian & Oceanian Studies, CICIR |
| 28 | Anonymous | Researcher | 中国现代国际关系研究院南亚东南亚及大洋洲研究所<br>Institute of South & Southeast Asian & Oceanian Studies, CICIR |
| 29 | Anonymous | Professor | 南开大学周恩来政府管理学院国际关系系<br>Department of International Relations, Zhou Enlai School of Government, Nankai University |
| 30 | Anonymous | Assistant Professor | 对外经济贸易大学国际贸易经济学院<br>School of International Trade and Economics, the University of International Business and Economics |
| 31 | Anonymous | Professor | 外交学院当代中国外交研究中心<br>Foreign Affairs Department, China Foreign Affairs University |
| 32 | Anonymous | Researcher | 商务部国际贸易经济合作研究院亚非部<br>Department of Asia and Africa, Chinese Academy of International Trade and Economic Cooperation (CAITEC), Chinese Ministry of Commerce |
| 33 | Anonymous | Researcher | 商务部国际贸易经济合作研究院 |

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| | | | Department of China's Trade & Economic Relations, CAITEC, Chinese Ministry of Commerce |
| 34 | Anonymous | Professor | 中国人民大学国际关系学院<br>School of International Studies, Remin University |
| 35 | Anonymous | Professor | 中国人民大学全球治理研究中心<br>Centre for the Study of Global Governance, Remin University |
| 36 | Anonymous | Researcher | 中国人民解放军军事科学院世界军事研究部<br>Department of World Military Research, Chinese People's Liberation Army Academy of Military Science |
| 37 | Anonymous | Associate Research Fellow | 中国国际问题研究所国际战略研究部<br>Department of International and Strategic Studies, CIIS |
| 38 | Anonymous | Researcher | 国家发展和改革委员会对外经济研究所<br>Institute of International Economic Research, Academy of Macroeconomic Research, Chinese National Development and Reform Commission (NDRC) |
| 39 | Anonymous | Researcher | 国家发展和改革委员会产业经济与技术经济研究所<br>Institute of Industrial and Technological Economics, Academy of Macroeconoimc Research, NDRC |
| 40 | Anonymous | Professor | 北京大学国际关系学院<br>Department of International Political Economy, School of International Studies, Peking University |
| 41 | Anonymous | Former senior diplomat | 中国国际交流促进会<br>China International Exchange Association |
| 42 | Anonymous | Senior diplomat | 中国外交部北美大洋洲司<br>Department of North American and Oceanian Affairs, Chinese Ministry of Foreign Affairs |

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| 43 | Anonymous | Associate Professor | 上海大学悉尼工商学院<br>Sydney Institute of Language & Commerce, Shanghai University |
| 44 | Anonymous | Professor | 华东师范大学澳大利亚研究中心<br>Australian Studies Centre, East China Normal University |
| 45 | Anonymous | Lecturer | 厦门大学经济学院<br>School of Economics, Xiamen University |
| 46 | Anonymous | Assistant Professor | 上海外国语大学国际关系与外交事务研究中心中国海外利益研究中心<br>Centre for China's Overseas Interests Studies, School of International and Diplomatic Affairs, Shanghai International Studies University |
| 47 | Anonymous | Senior manager | A Chinese minerals import and export company |
| 48 | Anonymous | Senior manager | A Chinese minerals import and export company |

**Trip 4: Australia (Canberra and Sydney), March-April 2011**

| **No.** | **Name** | **Position** | **Organisation** |
|---|---|---|---|
| 49 | Anonymous | Professor | Department of International Relations, School of International, Political and Strategic Studies, the Australian National University (ANU) |
| 50 | Anonymous | Professor | Department of International Relations, ANU |
| 51 | Anonymous | Professor | Strategic and Defence Studies Centre, School of International, Political and Strategic Studies, ANU |
| 52 | Anonymous | Professor | School of Politics and International Relations, ANU |
| 53 | Anonymous | Senior Lecturer | Department of International Relations, ANU |
| 54 | Anonymous | Emeritus Professor | Department of International Relations, ANU |
| 55 | Anonymous | Emeritus Professor | East Asian Bureau of Economic |

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| | | | Research, Crawford School of Economics and Government, ANU College of Asia and the Pacific, ANU |
| 56 | Anonymous | Senior Fellow | China Economy Programme, Crawford School of Economics and Government, ANU |
| 57 | Anonymous | PhD candidate | Department of International Relations, ANU College of Asia and the Pacific, ANU |
| 58 | Anonymous | Visiting Fellow | College of Law, ANU |
| 59 | Anonymous | Professor | The ANU China Institute, ANU College of Asia and the Pacific, ANU |
| 60 | Anonymous | Senior columnist | The Australian Financial Review |
| 61 | Anonymous | Senior Analyst | Strategy and International Programme, the Australian Strategic Policy Institute (ASPI) |
| 62 | Anonymous | Senior Lecturer | School of Humanities and Social Sciences, the University of New South Wales (UNSW) at the Australian Defence Force Academy (ADFA) in Canberra |
| 63 | Anonymous | Professor | School of Humanities and Social Sciences, UNSW at ADFA in Canberra |
| 64 | Anonymous | Professor | School of Humanities and Social Sciences, UNSW at ADFA in Canberra |
| 65 | Anonymous | Professor | School of Humanities and Social Sciences, UNSW at ADFA at Canberra |
| 66 | Anonymous | Senior Research Fellow | The Lowy Institute for International Policy |
| 67 | Anonymous | Senior analyst | The Kokoda Foundation |
| 68 | Anonymous | Official | Australian Department of Foreign Affairs and Trade (DFAT) |
| 69 | Anonymous | Senior diplomat | DFAT |
| 70 | Anonymous | Senior diplomat | Chinese Embassy, Australia |
| 71 | Anonymous | Research Fellow | China Research Centre, the University of Technology Sydney |
| 72 | Anonymous | Senior analyst | The Lowy Institute for International Policy |
| 73 | Anonymous | Research Fellow | The Lowy Institute for International Policy |
| 74 | Anonymous | Researcher | Peking University |
| 75 | Anonymous | Professor | Centre for International Security Studies, |

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| | | | the University of Sydney |
| 76 | Anonymous | Research Fellow | The Centre for Independent Studies |
| 77 | Anonymous | Senior analyst | The Lowy Institute for International Policy |
| 78 | Anonymous | Reader | School of Social Sciences & International Studies, UNSW |
| 79 | Anonymous | Associate Professor | Centre for International Security Studies, the University of Sydney |
| 80 | Anonymous | Anonymous | China Studies Centre, the University of Sydney |

**Additional interviews in London, October-December 2012**

| No. | Name | Position | Organisation |
|---|---|---|---|
| 81 | Anonymous | Professor | Strategic and Defence Studies Centre, School of International, Political and Strategic Studies, ANU |
| 82 | Anonymous | Official | 中国外交部<br>Chinese Ministry of Foreign Affairs |
| 83 | Anonymous | Official | 中共中央对外联络部<br>International Department of the Central Committee, Communist Party of China |
| 84 | Anonymous | Diplomat | Australian High Commission, London |