

Background Papers*

Panel I: What does China want from the region?

The question of how China intends to use its increasing power in the coming decades and what its underlying strategic intentions are affects every discussion about our region's future. Yet there remains significant uncertainty as to what China actually wants from the region. Does China want to become the dominant power and norm-setter in the region or does it envisage a continued strong presence of the US and adherence to existing norms?

In a number of major foreign policy speeches, President Xi Jinping has articulated a vision for international affairs in the Asian region and China's role within it. In remarks to the Peripheral Diplomacy Work Conference in October 2013, President Xi spoke of China's desire to forge closer relationships with countries on its periphery and to develop greater regional influence. He described China's desire to construct a new integrated regional economic system in Asia with greater interconnection through the Silk Road Economic Belt, Maritime Silk Road and the Asian Infrastructure Investment Bank (AIIB).

In a speech on a new Asian security concept in 2014, President Xi said China would get "more deeply involved in the regional cooperation process" and play its part to ensure that "development and security in Asia facilitate each other and are mutually reinforcing." He advocated the establishment of a new regional security architecture and observed that "it is for the people of Asia to run the affairs of Asia, solve the problems of Asia and uphold the security of Asia."

At this year's Boao Forum President Xi further elaborated his vision of building a "community of common destiny" in Asia. He advocated a new type of international relations based on win-win cooperation, with greater collaboration in economic, political, security and cultural fields. President Xi said countries should treat each other as equals, respecting their different social systems, development paths and core interests, and avoid interference in others' internal affairs. At the same time the "legitimate security concerns" of each country must be respected and addressed, taking into account "both the history and reality of Asia."

China's more assertive actions in recent years in the East and South China Seas have also increased regional tensions. Examples of China's contentious behaviour include the ongoing construction of artificial islands in disputed areas of the South China Sea, Beijing's declaration in 2013 of an Air Defence Identification Zone (ADIZ) in the East China Sea which included the disputed Senkaku/Diaoyu Islands, and the placement of a deep sea oil rig in disputed waters near Vietnam in 2014. Construction of artificial islands in the South China Sea, some of which appear designed for the construction of runways suitable for military aircraft, has raised concerns that China may intend to declare an ADIZ over the South China Sea and seek to control navigation through sea lanes critical for international trade and US force projection.

Australia reacted strongly to China's declaration of an ADIZ in the East China Sea in November 2013, with Foreign Minister Julie Bishop calling in the Chinese ambassador to express the

* Thank you to Eva O'Dea, Professor Michael Wesley, Neil Thomas and a number of anonymous reviewers for these background papers.

government's concerns. She criticised the timing and the manner of China's announcement, saying it would not contribute to regional stability, and reiterated Australia's opposition to coercive or unilateral changes to the status quo in the East China Sea. The Chinese foreign ministry described Australia's statements on the ADIZ as "irresponsible" and "completely mistaken".

Over the ensuing months a "diplomatic remodulation" by the Australian government (in the words of former Foreign Minister Bob Carr) appeared to take place. The government avoided repeating descriptions by Prime Minister Tony Abbott in late 2014 of Japan as Australia's "ally" and "best friend in Asia". The government's response to the deep sea oil rig incident in May 2014 was markedly softer than to the ADIZ issue, with the Department of Foreign Affairs and Trade rather than the Foreign Minister issuing a statement urging parties to exercise restraint and reiterating that Australia does not take a position on the dispute. The Foreign Minister has also avoided issuing an official statement on China's construction of artificial islands in the South China Sea. She also changed her itinerary and did not make a planned visit to Hong Kong during the pro-democracy demonstrations. Comments by the then Defence Minister David Johnston in June 2014 that he "did not believe" the ANZUS Treaty would commit Australia to a territorial dispute in the Asia Pacific attracted little public response from the government.

By November 2014, bilateral relations with China appeared significantly improved. During President Xi's visit to Australia for the G20 both governments announced the completion of negotiations on the China-Australia Free Trade Agreement and the upgrade of bilateral relations to a "comprehensive strategic partnership," involving strategic level cooperation on political, economic, cultural and military issues. Australia applied to become a founding member of the China-led AIIB just before the deadline in March 2015, after much hesitation due to US opposition and concerns about how the AIIB will be governed.

Despite outward signs of closer political ties, however, in private Australian government officials and political leaders often indicate a deep distrust of China and the need to find an appropriate framework to deter China. This view was reflected in the private comments made by Prime Minister Tony Abbott at the time of the G20 that Australia's approach to China was based on "fear and greed". The extent to which this fear may be justifiable depends on a better understanding of what China's regional ambitions are.

Questions to consider

- Does China desire to be the dominant regional power at the exclusion of the US? If so, what changes will China likely pursue in terms of international institutions, norms etc.
- How likely is it that China's vision for international affairs might be realised?
- What is China likely to expect of its neighbouring or 'peripheral' countries including Australia?
- Are China's strategic objectives likely to be more inimical, or more favourable, to Australia's interests?
- How should Australia respond?

Panel II: How should Australia prepare for an alternative regional economic order?

There is an extensive debate over whether, as it becomes the world's largest economy, China will shift the basic rules of the international economic order. On one side of this debate are figures such as Ian Bremmer and Pat Choate, who argue that China has developed a form of "state capitalism", and that the twenty first century will therefore be dominated by a contest of state versus market capitalism. On the other side of the debate is John Ikenberry, who argues that the global liberal order is both easier for China to join and harder for it to overturn than the orders confronted by previous rising powers. Another version of this argument is provided by Edward Steinfeld, who argues that China is "playing our game" – i.e. that the record of China's engagement with the global economy shows it has a very high rate of compliance with existing norms, and a very low rate of challenge or non-compliance with those norms.

Another take on this debate focusses on whether growing strategic rivalry with the US will see China challenge the regional economic order, driven by a belief that the existing order underpins US power in Asia. The rise of "competitive regionalism" in the form of alternative trade agreements, the Trans-Pacific Partnership (TPP) (which is driven by the US but excludes China) and the Regional Comprehensive Economic Partnership (RCEP) (which includes China but excludes the US) has led Michael Wesley to speculate about whether the region may see the emergence of overlapping but alternative regional economic orders. The TPP as it takes shape appears to be a hyper-liberal regime particularly conducive to American commercial and investment interests, enforcing rules against state-owned enterprises and enforcing strict intellectual property provisions, for instance, while RCEP concentrates much more closely on facilitating trading and investment synergies, especially among developing economies. Aaron Friedberg has gone so far as to speculate on the emergence of two mutually-exclusive trade and investment blocs: one continental and centred on China, combining state-capitalist economies; and one maritime and centred on the US, combining market-capitalist economies.

There may be additional purchase on these debates by examining developments within China itself. The Chinese economy has embarked on a process of economic reform and restructuring that seeks to move it from an export-oriented centre of production to a major consumption and outward investing economy. In parallel to this, in 2012 the Chinese Foreign Ministry established a Department of International Economic Affairs to drive and integrate China's economic diplomacy. The accession of Xi Jinping to the Presidency has inaugurated or invigorated several new or emerging strands of economic diplomacy. President Xi has announced a major strategic conception under the slogan "One Belt, One Road" (1B1R), consisting of the New Silk Road Economic Belt and the Twenty-First Century Maritime Silk Road. Both are envisioned as extensive networks of Chinese commerce, investment and infrastructure projects extending along the country's key strategic trade routes west and south. President Xi and his colleagues have committed US\$40 billion to a Silk Road Fund and created the multinational US\$50 billion Asian Infrastructure Investment Bank (AIIB) to finance 1B1R. The overarching aim of these institutions is to align the interests of regional or "peripheral countries" with China's continued rise. President Xi has also spoken of the necessity for China to secure its growth by creating a "more enabling international environment".

The AIIB joins the US\$100 billion New Development Bank (NDB, or more commonly referred to as the “BRICs Bank”) as a brace of new, China-sponsored and funded institutions that rival existing institutions such as the World Bank and the Asian Development Bank, with a focus on providing multilateral funding for infrastructure building. One could also add to these China’s championing of currency-swap initiatives, both through the Asian Chiang-Mai Initiative (CMI) and via a range of bilateral currency swap arrangements involving the *renminbi*. There have been a range of motives ascribed to the launch of these new initiatives. One is the significant and justified resentment at the shortfall between China’s economic size and its voting weights in the Bretton Woods institutions – currently, as the second largest economy in the world, China has a voting weight within the IMF slightly less than Belgium’s. Another motive is said to be a difference in philosophy between China and the West over the prioritisation of development needs in emerging economies. While China and other developing powers emphasise the need to build infrastructure, the approach of Western countries tends to focus more on issues such as education, health and rights.

Diplomats involved in China-hosted multilateral meetings, such as the 2014 APEC meeting and upcoming G20 Summits, are cautious about drawing conclusions from China’s multilateral hosting agendas and its broader goals; they argue that hosting events that are considered successful is a major goal for Beijing. Nevertheless, China’s strong advocacy of launching a study into a Free Trade Area of the Asia Pacific (FTAAP) at the 2014 APEC Summit could presage the beginning of a major Chinese initiative to subsume TPP and shape the regional economy into what it sees as a “more enabling international environment” for the Chinese economy. President Obama warned of this in May while promoting the TPP, saying: “If we do not help to shape the rules ... then China will set up rules that advantage Chinese workers and Chinese businesses.” At this early stage, however, it remains to be seen what shape a Chinese-led economic regional order might take.

Questions:

- Would a China-led regional economic order be inconsistent with the existing liberal world order? What does it mean for the Bretton Woods institutions?
- What are the potential benefits and costs to Australia’s interests in China’s challenge to the regional economic status quo?
- What should be Australia’s long-term goal in responding to China’s economic challenge, and what strategies should it adopt?
- How should Australia seek to influence emergent Chinese economic initiatives such as the AIIB? What role should it endeavour to play within these Chinese-led organisations and initiatives?
- How likely is it that both the TPP and RCEP will be successfully agreed and ratified by member states? As a participant in both processes, how does Australia see the agreements interacting (assuming both are successfully completed)?

Panel III: Chinese infrastructure investment in Australia: Are concerns warranted?

Current debate over Chinese infrastructure investment in Australia is reflective of broader concerns about how to balance the potential economic benefits of closer partnerships with China with perceived security risks. The tone of debate has tended to become particularly emotive when it concerns Chinese investment in critical infrastructure or agricultural land.

As a country with a small population, Australia has always relied on foreign capital to help fund its infrastructure requirements — mostly from the US, the UK and Japan. The Business Council of Australia estimates that Australia needs at least an extra A\$400 billion of non-federal spending on infrastructure construction over the next ten years.

Investment from China is a prime contender to meet a significant share of Australia's infrastructure spending shortfall. In part this is because Beijing now seeks to diversify part of its US\$4tn of foreign exchange reserves from low-yielding US Treasury bonds to higher-yielding investment projects abroad. In terms of total foreign investment in Australia, investment from China remains small. As of December 2014, China (excluding Hong Kong SAR) accounted for just 4.4% of the total stock of foreign direct investment in Australia. But growth rates of Chinese investments in recent years have increased substantially. According to KPMG, Chinese investment in Australia between 2005 and 2013 represented 12% of total Chinese foreign investment, making Australia its second largest investment destination.

Senior Australian intelligence figures have spoken publicly about the vulnerability of Australia's critical infrastructure networks, particularly electricity networks, to cyber-attack. Former director-general of the Australian Security Intelligence Organisation David Irvine has said, "I know China probably has the ability already to turn off our electricity supply" (*AFR*, 9.3.2015). In 2013 he warned that the online integration of electricity, transport and communications infrastructure represents a vulnerability in cyber warfare because they were not designed with cyber threats in mind.

The Australian business community, in turn, is generally a vocal supporter of increased Chinese investment. Some business executives have been publicly critical of the foreign investment approvals process. Although the Foreign Investment Review Board (FIRB) has only blocked three projects since 2005, research by the Australia-China Business Council suggests some Chinese investors perceive Australia's investment process as cumbersome and targeted at China. By an OECD survey, Australia is now the sixth most restrictive OECD country for foreign investment. Anecdotal evidence suggests that some Chinese investors perceive they are not welcome in Australia, overestimate the barriers to investment or, at times, feel discouraged by the FIRB before submitting an application.

All investment from State Owned Enterprises (SOEs) remains subject to FIRB review and the "national interest test", which is determined by the Treasurer. The Chinese government is seeking to modify this automatic review of SOE investment when the ChAFTA is jointly reviewed in two years' time.

Polling by the Lowy Institute between 2009 and 2014 shows a consistent majority (50-57%) of Australians thought the government allowed “too much investment from China”. Concerns raised in public debate centre on the notion of “selling off the farm”, the perceived flight of profits and jobs from Australia, the risk of sales to controlled entities at non-market prices, compromised food and resource security, and the risk of strategically acquired assets being the subject of manipulation or control by the Chinese government in the event of a crisis or conflict. Investment from other countries does not appear to attract the same level of attention, although there was resistance towards Japanese ownership some decades ago.

Much of this concern stems from the prominent role of SOEs in Chinese outward investment. Some Chinese SOEs receive government assistance to invest abroad and there are concerns that they take orders from the Chinese state. The influence of the Chinese government in the activities of ostensibly private entities has also been a concern and is an issue that has often been difficult to clarify.

Proposed Chinese investment has at times become highly politicised. Most recently, during the 2015 NSW election campaign, NSW Labor Opposition Leader Luke Foley criticised the Coalition Government when it was revealed that Premier Mike Baird had met with the Chinese-owned State Grid Corporation about tendering for the proposed 99 year lease on a 49% stake in the State’s electricity distributors. Mr Foley suggested a sale to State Grid would present a national security risk because of its ability to potentially cut off the State’s electricity and gather intelligence on the Australian military. A number of commentators accused the Opposition leader of stoking xenophobia for political gain.

Other Chinese infrastructure investments do not become politically contentious. In December 2013, the Federal Treasurer approved the purchase by China’s State Grid Corporation of 60% of Jemena, an Australian owner and operator of electricity, gas and water infrastructure. In April 2015, the Treasurer approved the sale to SOE China Communications Construction Company of John Holland, an Australian construction company which is a key provider of construction services to the Defence Department. Both sales drew sparse attention outside the business press.

With Australia’s continued need for foreign investment in infrastructure, striking the right balance between risk and reward is critical.

Questions

- How should concerns over investment in significant infrastructure from Chinese SOEs and private entities with government links be balanced with the need for greater infrastructure investment in Australia?
- Are the mechanisms for discussing and mediating these issues with China, particularly the question of SOEs, sufficiently robust and effective, and if not, what is needed?
- Are concerns about perceived difficulties negotiating the FIRB process among some Chinese investors warranted? Should the Australian government seek a greater reciprocity from China’s investment regime for future changes to Australia’s investment rules?