

Mine your own business!

*Economic interdependence and Sino-Australian relations in
the 2000s*

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Summary

This thesis is a case study of the Sino-Australian economic interdependence relationship from 2000-2013. The period has been characterized by an explosion of mineral trade, with Australia in the role of exporter, and China in the role of importer. In particular one mineral has stood out as the most important in the trade relationship: iron ore. The drastically altered pattern of trade has tied the two countries closer, making them ever more dependent on each other. With Hirschman's dependency theory as a point of departure, this study seeks to draw out the political consequences of this increasing interdependence. In light of their differences in culture, ideology, form of government, relations to the US, and at times economic interest, there has been persistent conflict throughout the 2000's on many policy areas. This thesis asks whether the increased economic transactions have led to a balanced or asymmetric economic relationship, and how this new interdependence has affected each side's political leverage over its counterpart. It is argued that the economic interdependence relationship between the two countries, despite what it might seem from the outside, is relatively balanced. Each party seems equally dependent on the other, and this also seems to have an effect on the political leverage of each party. Through reviewing four central policy areas of conflict, the thesis finds that the political leverage of the two countries seems fairly balanced, with Beijing not able to move Canberra to any large degree in any conflict area. The causal mechanism of economic pressure is suggested as a possible pathway from balanced interdependence to a 'political stalemate' in the Sino-Australian case.

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Table of Contents

1	Introduction.....	1
1.1	Background and Purpose	1
1.2	Research Question and Scope of the Thesis	3
1.3	Theoretical background.....	4
1.4	The Argument in Brief.....	7
1.5	Structure of the thesis	9
2	Theory and Review of Literature	11
2.1	Conceptualizing Economic Interdependence	11
2.1.1	Dependence following Hirschman.....	11
2.1.2	A qualitative distinction: sensitivity and vulnerability	15
2.1.3	Summary.....	17
2.2	Dependence and Raw Materials	18
2.2.1	Resource security: reliability and price	18
2.2.2	Sensitivity, market structure and the role of multinational corporations.....	20
2.2.3	Summary.....	23
2.3	From Dependence to Political Leverage.....	23
2.3.1	Economic pressure.....	23
2.3.2	Vested and changing interests	28
2.3.3	Exchanging power?.....	29
2.3.4	Summary.....	30
3	Method of Inquiry.....	32
3.1	Goal of the Research.....	32
3.2	Research Design.....	32
3.2.1	Causal model.....	33
3.2.2	Operationalization of key concepts	35
3.2.3	Generalization.....	38
3.3	Collection of Data and Methodological Challenges	38
3.3.1	Picking respondents for the interviews.....	39
3.3.2	Semi-structured interviews.....	40
3.3.3	Methodological challenges	41
4	The Economic Interdependence Relationship	42
4.1	The Balance in the Dependence Relationship.....	42

4.1.1	Dependence on the China as a market for exports.....	43
4.1.2	Easily replaceable and critical goods.....	47
4.1.3	Alternative markets and sources of supply.....	51
4.1.4	Summary.....	54
4.2	Interpreting the Results.....	54
4.2.1	Australia’s sensitivity and vulnerability.....	54
4.2.2	China’s sensitivity and vulnerability.....	58
4.2.3	Economic pressure.....	62
4.3	Economic Interdependence Summarized.....	63
5	Conflicting interests and political leverage.....	65
5.1	Economic Conflict: Trade and Investment.....	65
5.1.1	The interests of the two parties.....	66
5.1.2	China’s resource diplomacy and government-led investment program.....	67
5.1.3	China demands intervention in the market, Australia sticks to free market approach 70	
5.1.4	Chinese investment and the Australian government’s response.....	72
5.1.5	Escalating the ‘ore wars’: Arresting Stern Hu and the breakdown of price negotiations.....	83
5.1.6	The result of high prices or a tough line on investments?.....	87
5.1.7	Divergent business interests and political opposition against Chinese FDI.....	89
5.1.8	Summary.....	94
5.2	Economic and Defense Interests Colliding?.....	95
5.2.1	The interests of the two parties.....	96
5.2.2	The Howard years.....	97
5.2.3	Multilateral engagement with bilateral vigor.....	101
5.2.4	American troops in Darwin, Huawei and the 2013 Defense white paper.....	104
5.2.5	Little interest in lobbying.....	105
5.2.6	Summary.....	106
5.3	Differing Values: Australia’s Criticism of Human Rights Abuses.....	107
5.3.1	The interests of the two parties.....	107
5.3.2	A complex approach.....	111
5.3.3	Uighur riots, ETIM and a visit by Rebiya Kadeer.....	113
5.3.4	Successful and unsuccessful attempts at lobbying.....	115
5.3.5	Summary:.....	117

5.4	Implications of economic interdependence in the 2000s	117
5.4.1	Ability of the two to use economic pressure.....	118
5.4.2	Little interest in lobbying for Chinese interests	123
5.4.3	Exchanging Power?.....	124
6	Implications and conclusion.....	127
6.1	Empirical findings	127
6.2	Theoretical Implications	129
6.3	Concluding remarks	130
	Literature	131
	Appendix	147

Table of Figures

Figure 1	Causal model	35
Figure 2:	Composition of Australia's exports to China 2001 and 2011.	44
Figure 3:	Annual Steel Production 2000-2012 (mtpa), China and rest of the world.	49
Figure 4:	China's steel consumption by sector.....	50
Figure 5:	Major resources projects in Australia (2012).	57
Figure 6:	Seaborne iron ore by supplier.....	60
Figure 7:	Iron ore prices in the 2000s.	61

Overview of tables

Table 1:	Australia's relative dependence on bilateral merchandise trade with China.....	43
Table 2:	Australia's iron ore exports to China	45
Table 3:	Coal exports as a percentage of total trade with China.....	45
Table 4:	China's import dependency rate for selected minerals.....	47
Table 5:	China's dependence on iron ore imports 2000-2009	48
Table 6:	Chinese steel consumption by industry, selected years.....	50

Table 7: Australia's top mineral exports to China 2011.....52

Table 8: Visits by Dalai Lama to Australia and receptions by Prime Ministers.....111

1 Introduction

1.1 Background and Purpose

During the 2000s Australia and China have rapidly expanded their trade with each other. According to Chinese trade data the value of Australia–China bilateral merchandise trade surged nine times from 2002 to 2010. Most of this increase in trade comes from Australian exports to China, which increased from US\$ 5.850 billion in 2002 to US\$ 60.870 billion by 2010, making China Australia’s main trading partner (Sen 2012:106). The main reasons for this swift alteration of trade patterns has been the complementarity between their two economies: China’s exponentially growing demand for raw materials, and Australia’s close proximity and ability to provide a range of them because of its resource abundance.

Over the 2000s China and other emerging economies’ demand for resources has been one factor causing steep price-climbs for many raw materials. This has especially been the case for oil and different metal minerals. In the late 1990s low prices resulted in low levels of investment, little expansion of production, and closure of high cost capacity (Streifel 2009:3). The 2000s was characterized by the exact opposite. The Australian mining industry experienced a double investment boom in this period (Ergas and Owen 2012:13), and the country as a whole experienced high growth rates even as other developed countries felt the impact of the global financial crisis (GFC). Australia has become a leading supplier of among others iron ore, copper, nickel, zinc and other minerals, as well as coal and liquefied natural gas (LNG). China has rapidly become an important market for all of these commodities. In 2011-2012 29.1 percent of Australia’s total exports ended up in China, and 18.1 percent of Australia’s imports came from China. However, the size of the Chinese economy relative to that of Australia is striking: the imports of Australian commodities only represent 4.7 per cent of China’s total for the same year, and the exports to Australia only 1.8 per cent (DFAT 2012b). Australia is therefore increasingly dependent upon China for its continued growth – has Beijing been able to exploit this newfound dependence?

The other side of the story is that China has become increasingly dependent on Australia as a source of many key commodities. For a whole range of raw materials China has become the number one consumer. It consumes near a fourth of total global production of the ‘main metals’. Approximately two thirds of the total growth in world metal production was destined for China (Streifel 2009:3-5). China’s appetite for raw materials, and its push to secure them in needed

quantities, has been given increased attention both in scholarly circles and western media. The Economist for instance noted in 2008 that: 'From Canada to Indonesia to Kazakhstan, Chinese firms are gobbling up oil, gas, coal and metals, or paying for the right to explore for them, or buying up firms that produce them' (The Economist 2008). Resource security, or the continuous availability of needed resource inputs at reasonable prices, has come into increasing focus (UNDP 2000: 112). According to Beeson, Soko and Young (2011:1367) 'resource security has become so important to China as to be reshaping its entire approach to foreign policy'. Many observers have also noted that the Chinese government relies heavily on 'performance legitimacy'. Keeping the process of economic development going is the key rationale for their legitimacy, and resource security is an important aspect of this implicit domestic agreement¹.

Beyond the complementary of their economies, they certainly are an odd couple. Australia has a shared heritage of language, culture and ideas with the other Anglo-Saxon countries, and has been a strategic ally to the US in the region since the end of the Second World War (Keohane and Nye 2012:150). In fact, Australia's most important trading partners has historically either been its key security partner (the UK and the US) or an ally of its key security partner (Japan), and all of these have been democracies. Australia's new main trading partner is an authoritarian state ruled by the Communist Party of China, with a relationship to Australia's main security partner that is complicated to say the least. From another perspective, their economic systems differ widely. While liberal economic thoughts and private ownership dominate in Australia, the picture is more complex in China. China has made a gradual transition towards western capitalism, privatizing small and medium businesses, but the government still has tighter control of the 'commanding heights' of the economy. As noted by Mark Thirwell, Program Director of International Economy at the Lowy Institute for International Policy: 'for the first time, our largest trading partner is authoritarian, a quasi-mercantilist, and a strategic competitor of our major ally' (Economics References Committee 2009a:66).

This brings new challenges. As noted by Beeson, Soko and Young (2011:1371) 'Few countries illustrate the diplomatic complexities that flow from China's rise more than Australia'. Reflecting these differences there are areas where Australian and Chinese interests have clashed over the last decade. Four areas of special interest are (1) the pricing of some key commodities, (2) Australia's investment policy, (3) defense politics, and (4) human rights. The skyrocketing prices of iron ore has been a constant challenge in Sino-Australian diplomacy over the past ten years; some

¹ Former President Hu Jintao himself has stated that an economic downturn will pose a challenge to the Communists Party's ability to rule (Elegant 2008).

commentators have labeled it the ‘ore wars’. When Chinese companies started investing heavily in Australia’s resources sector in 2008-2009, Australian authorities seemingly sought to limit their influence by introducing new FDI guidelines for state owned entities (SOEs). The most quoted example by now is Chinalco Mining Corporation International’s (Chinalco) failed acquisition of a larger share in Rio Tinto Zinc (Rio Tinto) in 2009, although this deal was not ultimately struck down by Australian authorities but by the shareholders of Rio Tinto. Equally, the two countries differing defense priorities and opposite approach to human rights have made relations tense.

With rapidly increasing economic transactions, and large alteration in the trade relationship, one could expect that the power relationship between the two countries governments might have changed too. Especially in light of the many clashes in key policy areas, a central question is: *has the increased economic dependence affected each of the two countries strength at the negotiating table – and if so, how?*

1.2 Research Question and Scope of the Thesis

The scope of this thesis is to investigate how rapidly increasing trade and investment between China and Australia has affected their political relationship. This will be done by exploring how their differences in these three policy areas, to evaluate how the increased economic interdependence has affected each sides political leverage over the other. Through assessing the economic dependence of each party, and analyzing how the countries have fared in key conflict areas, it will be evaluate how the increased economic interdependence has affected each side’s political leverage over the its counterpart. This goal is reflected in the research question:

How has the balance or asymmetry in economic interdependence between China and Australia affected each side’s political leverage over its counterpart?

The first part of the question underlines that the thesis is concerned with the political leverage that springs from economic interdependence balance or asymmetry. Interdependence in world politics refers to a situation characterized by reciprocal (but not necessarily symmetric) costly effects of transactions among countries or among actors in different countries (Keohane and Nye 2012:7-8). We can speak of military-, economic- and other forms of interdependence; but this thesis is concerned with economic interdependence. Theoretically, the thesis draws inspiration particularly from Hirschman (1980), Keohane and Nye (2011), Baldwin (1980), Crescenzi (2002), Hveem (1978; *forthcoming*) and Hveem and Malnes (1980).

Political leverage is understood as the ability to make the counterpart do something that it does not perceive to be in its interest. This definition is similar to a broadly accepted definition of power as an actor's ability to pursue autonomous policies and to get other actors to do something they would not otherwise do, at an acceptable cost (Keohane and Nye 2012:10), although it also brings into focus that it is the perceived interests of the governments that matter. By defining political leverage in this way and by emphasizing that it is the perceived interests of governments that matter, one can distinguish between situations where government interests change over time and those situations where the counterparts has forced it to accept an outcome that it did not perceive to be in its interest. I have deliberately asked 'how', because I am interested in the causal mechanisms through which economic asymmetry translates (or does not translate) into political leverage. The thesis is also restricted to the areas that have been selected: prices and investment policy, defense policy and human rights.

Before turning to the argument, I will briefly assess some of the most relevant literature; that is dependency theory with an emphasis on the (asymmetric) interdependence case; and on the Sino-Australian interdependence relationship in particular. This is done to put the argument of the thesis in a broader theoretical and empirical context and show where it seeks to make a contribution.

1.3 Theoretical background

There is a great deal of debate in Australia about the relationship with China. One of these debates revolves around the question of whether Australia has sought and should seek to accommodate China through closer strategic alignment or rather balance against China through closer alignment with the US, and whether this choice is linked to increased economic dependence (Kurlantzick 2007; Kagan 2008; Manicom and O'Neil 2010; O'Neil 2011; Baogang 2012; Reilly 2012). This is part of a broader debate in the realist literature about whether secondary states accommodate or balance against rising powers, and whether or not economic dependence affects their decision. The debate has also centered on the increased economic dependence of neighboring countries in Asia on China. Central to these debates is the question of whether China's increased importance as a market for products of these countries gives China leverage to influence their strategic choices (Ross 2010).

As Reilly (2012:373-374) points out these debates have suffered from varying definitions of alignment concepts, have lacked reliable indicators for alignment behavior, and generally a

tendency to confuse causes and effects. However they also suffer from underdeveloped theoretical conceptualizations of economic dependence, something that is naturally reflected in their measurement of the concept. While many of these studies claim to draw their theoretical ‘expectations’ from Hirschman’s 1945 classic *National Power and the Structure of Foreign Trade*², a book that has received a resurgence of interest in later years, few of them appreciate the complexity of Hirschman’s work; nor the rich theory of economic interdependence that has developed since Hirschman’s classic.

To be more specific about what is lacking, there tends to be too much focus only on one side of a two-sided relationship; how other states will ‘respond’ to the ‘rise of China’. It has become quite fashionable in the realist literature to cite Hirschman, but the common reading of his argument is quite narrow. The ‘political economy argument’ that is derived is that the smaller economies (South-East and East Asian states plus Australia) should accommodate the larger economy as economic interdependence (two-way trade) increases, because that trade will represent a larger part of the smaller economy’s total trade. This is then held up against a rival realist argument that says that these states should balance against the rising power. The indicators that are often used to measure economic interdependence are the proportion of the countries’ total trade with each other (in some cases also the proportion of investment)³. But that is not necessarily the only factor that determines who is most dependent on whom economically. Some have called for also taking the commodities that are traded into account when measuring economic dependence (Blanchard and Ripsman 1996). By doing this one can perhaps better appreciate the Chinese part of the story. In relation to South-East and East Asian states, China’s economic leverage may be limited by the fact that close to two thirds of its trade with these states is processing trade. This means that China to a large degree imports intermediate goods from the rest of Asia, that are made into the end product in China and exported to the US and Europe. It is not a given that the assembling of these goods happens in China (Lee 2012:155).

In relation to Australia, it ignores the vast literature on China’s quest for energy- and resource security that has emerged over the last decade (Lan et al 2013; Wilson 2011a⁴; 2011b; 2012; Ravenhill 2013a; 2013b), and also the scholarship on mineral trade that was developed during the 1970s and 1980s (Hveem 1978; Hveem and Malnes 1980; Maull 1984). While this factor is lacking

² The second edition of his book, from 1980, is used in this thesis.

³ Reilly (2012:378) does take China’s dependence on Australia into account, writing that: ‘Australia’s economic dependence upon China, however, should not be overestimated. Clearly, the relationship is one of mutual dependence’. However, the consequences of this are not properly reflected in the rest of his article.

⁴ Jeffrey Wilson made his Ph.D. Thesis available for this project. His newly released book (Wilson 2013) is based on the thesis, slightly shorter, and more updated.

in the contributions mentioned it is appreciated by many in the International Political Economy (IPE) tradition focusing on the Sino-Australian relationship (Lee 2012; Wilson 2011a; 2011b; 2012; Beeson, Soko and Yong 2011; Leaver and Ungerer 2010), and also by commentators and people ‘in the loop’⁵. Ambassador to China in the period 2007-2011 Geoff Raby in a recent speech claimed that⁶:

China’s heavy reliance on Australia’s mineral and, increasingly, energy resources is a significant national asset for Australia in our diplomatic dealings with China. It gives us a level of influence well beyond our size in terms of population or geo-strategic importance (Raby 2010).

An assessment of the Sino-Australian dependence relationship should take into account the commodities that are traded, and by extension also the alternative markets and sources of supply of the two states.

Another problem with many of the above-mentioned contributions that is partly related to the first concern is that their focus is strictly on whether or not Australia has accommodated China, and not on how or why this happens. That dimension is lost in the attempts to categorize Australia’s response in terms of ‘balancing’, ‘accommodating’, ‘bandwagoning’, ‘hedging’ or the like. But *why* Australia chooses to do one or the other; how the government thinks about the economic dependence on China; is arguably the more interesting question. If Australia in some instances has accommodated China, is it like some prominent Australian strategic thinkers seem to think, the result of Chinese economic pressure to do so? Has Canberra ‘acquiesced to China’s demand that a strong economic relationship is conditional on a measure of compliance with Chinese wishes on key political and strategic questions’ (White 2005a:479), or has it stood relatively free to make its own choices on these issues? If the latter is the case, how can it be explained?

Part of the problem might be that the economic interdependence literature has not been very helpful in explaining exactly how asymmetric economic interdependence translates into political leverage (Hirschman 1980; Keohane and Nye 2012). Wagner (1988) has offered a thorough critique of both Hirschman and Keohane and Nye on this basis. His strongest critique is reserved for Keohane and Nye’s assertion that one side can use asymmetry to receive a more favorable outcome in a bargaining situation⁷. His critique is weakest with regards to Hirschman’s assertion

⁵ For instance economics editor of *the Australian*, David Uren, places much weight on this in his book *The Kingdom and the Quarry*.

⁶ Geoff Raby was also interviewed in the research process of this thesis.

⁷ See Crescenzi (2002) for a counter-critique, albeit one that is less relevant for this thesis.

that asymmetry in economic interdependence can give one side the ability to use interruptions of normal trade relations or threats thereof to achieve political leverage. Economic pressure, defined as ‘efforts at coercive or threatening economic behavior by an initiating government directed against a target government’ (Tanner 2007:12), is one possible way from asymmetry to political leverage. In line with what has been argued so far critical resources can act as a counter to attempts at economic pressure, because they can up the cost significantly of such pressure.

A simple but nonetheless analytically useful distinction when looking at the possibility for economic pressure is that between sensitivity and vulnerability; the first relating to how in tune a nation is to world markets or events taking place in foreign countries, the second relating to costs of interruption and thus the credibility of a threat (Crescenzi 2002; Cooper 1985; Baldwin 1980). If one side is vulnerable to interruption in economic relations while the other is not, then the cost of an interruption is highly unequal between the two. However, the parties can also make less serious threats concerning future economic opportunities. Another possible way from asymmetry to political leverage that works in combination with the first one is vested interests. Such vested interests are as a general rule mostly found in the smaller economy, but to take effect these interests must believe that they stand something to lose by not acting (Abdelala and Kirshner 1999).

While many of the concerns that have been raised here have been raised elsewhere in the literature, I have not found a comprehensive evaluation of the Sino-Australian relationship with economic interdependence as the main explanatory variable that has taken them all into account. This is where this thesis seeks to make a contribution. I seek to draw upon Hirschman’s classic and later scholarly works on the field of economic interdependence, exploring whether they can add something to our understanding of the case.

1.4 The Argument in Brief

The argument in this thesis takes aim at amending the shortcomings and challenges in some of the abovementioned literature. By drawing on a larger range of literature, with some of the most important contributions mentioned above, I seek to make a realistic assessment of the Sino-Australian dependence relationship. I also seek to find out how the economic dependence can translate into political leverage in the Sino-Australian case.

Firstly, I argue that the Sino-Australian economic interdependence relationship is fairly balanced if one takes into account the type of goods that is traded and the alternative markets and sources

of supply of the most important goods. Australia's dependence on China as a market for exports, particularly for iron ore exports, is balanced out by China's dependence on Australia for a range of critically important metal minerals, in particular iron ore, and to an increasing degree energy products. Furthermore the context of the period in question – a sudden rush in demand from China and other emerging economies for the above-mentioned raw materials – has meant that getting these raw materials in needed quantities and at reasonable prices has been a central issue for policymakers in China. China's dependence is, as mentioned, a point that is lost in some of the literature on the Sino-Australian economic relationship.

Secondly, I argue that making an analytical distinction between sensitivity and vulnerability is useful in understanding the nature of each country's dependency. Vulnerability is understood as the economic costs of interrupting economic ties, typically through interruption of trade flows in important goods. Sensitivity is understood as costs imposed from the outside under normal market conditions, typically through changes in demand or price rises or price falls in important commodities. China is vulnerable to interruption of supplies in international resource markets, directly vulnerable to Australia in iron ore, and China's steel sector is sensitive to rising prices in international mineral markets. Australia's economy as a whole is sensitive to alterations in demand and falling prices, and vulnerable to an interruption of trade flows in iron ore. This will be explained in detail later. What is important to note here, is that the distinction between vulnerability and sensitivity is used to highlight the nuances in each parties dependency, while still holding on to the point that both parties are equally dependent.

Thirdly, I argue that the balance in dependence is reflected in a balance in political leverage between the two countries in conflicts on central policy areas. In the issue areas that have been selected it is shown that neither party has been able to force its interest on its counterpart. When the conflicts in the issue areas have come to a head both parties have sought to prevent that they 'spill over' into the broader trade relationship. Such key episodes include the arrest of an Australian citizen and Rio Tinto Zinc's (Rio Tinto) chief negotiator in the annual iron ore negotiations with China, Canberra's introduction of a new foreign investment regime and Chinalco's failed bid for a larger share in Rio Tinto, the decision to allow 2500 US soldiers to be stationed in Darwin, and the Australian government's granting of a visa to a Uighur leader whom the Chinese regime views as a terrorist.

Fourthly, I suggest two causal mechanisms as potential pathways linking the balance in dependency to the balance in political leverage: economic pressure and vested interests.

Government economic pressure, which appears to be the most important causal mechanism, is separated into two: the most serious form of economic pressure relates to each party's vulnerability and involves interruption of trade or other economic ties that *are already in place*. The less serious form of economic pressure involves threats of taking *future economic opportunities* elsewhere. Both require a willingness to sacrifice economic gains in order to achieve something else, and the size of those economic costs can determine how willing the parties are to use economic pressure, and the credibility of the threat that is issued.

In the Sino-Australian relationship, none of the two governments seem able to make credible threats of the first kind. It seems that this is because both recognize that escalating further would spell out huge economic consequences for both parties. Australian leaders are aware that there exist alternatives to their raw materials, and for this and several other reasons Canberra would not issue economic threats towards Beijing. On the other hand Australia has a range of advantages that make it both more reliable than many of the alternative sources of supply for some materials and cheaper than the alternative sources of supply for other materials. Beijing seems not to be willing to apply even the more limited forms of economic pressure, indicating that they view the costs of this as too high. In short, each side's opportunity of using economic pressure cancels out the other, and neither side can credibly threaten the other.

The causal mechanism of vested interests, whereby business interests in the smallest economy can be expected to lobby the government if they believe they stand something to lose from a government disagreement with the government of an export market, does not seem as important in this case. Even though the Australian mining industry has taken on increased significance in Australian politics in later years, the business community in the country seems to lack the interest in lobbying Canberra over issues related to China. There certainly have been attempts – however, when pundits in the business community have tried to lobby the government into giving in to Chinese demands, the political counterforces have been considerable.

1.5 Structure of the thesis

Including this introduction, the thesis is divided into six chapters. Chapter two and three establishes the theoretical and methodological foundation of the thesis. In chapter two I review the most important literature on interdependence, and use this to lay out a framework for understanding economic interdependence in a bilateral economic relationship. Drawing on Hirschman (1980) I establish three indicators that can be used to determine who is most

dependent on whom in a bilateral economic relationship. Then I introduce an analytical distinction between sensitivity and vulnerability that is important for understanding the economic relation between Australia and China, and some background. In the last section of this chapter, I consider the potential causal mechanisms from dependency to political leverage. In chapter three I review the methodological basis for the thesis. First, I state the goal of the research. Then I assess the research design. I consider the causal model, operationalize the main variables and mechanisms, and consider the possibilities for drawing out general insights from the thesis. Lastly, I consider the collection of data and contemplate on potential methodological problems.

Chapter four and five are empirical chapters, where I establish the interdependence relationship and its political consequences in the Sino-Australian case. In chapter four I describe the economic interdependence relationship. I do this in two steps: First, I use the three indicators introduced in the theoretical part to assess whether the economic dependence relationship is balanced or asymmetric. Then I use the analytical distinction between sensitivity and vulnerability to interpret what this and other factors mean for each individual country. In chapter six I explore what consequences the economic dependence has had in areas where there have been conflicting interests. I assess the conflicts on (1) trade- and investment-, (2) defense-, and (3) human rights policies separately. I discuss the political leverage of each party, and the causal mechanisms linking the economic interdependence to the “balance of power” between the two. In the last part of the chapter I draw out the main points of the previous subchapters, and discuss the findings.

In chapter six, I summarize the main empirical and theoretical findings, assess some limits of the thesis, and conclude.

2 Theory and Review of Literature

This chapter lays out the theoretical framework for answering my research question. In short, I will lay out the way I will understand economic interdependence in a bilateral economic relationship, and by what mechanisms this interdependence can translate into political outcomes. I will put emphasis on the commodities that are traded, and how the sensitivity-vulnerability dimension relates to this. I will also discuss how it relates to the Australia-China relationship.

I will first argue that there are three factors that determines who is most dependent on whom in a bilateral economic relationship: (1) the total net gains which they receive from trade within the dyad, (2) whether the commodities traded are considered critical or non-critical and (3) the alternative markets and sources of supply that are available to both parties. Then I introduce an analytical distinction for determining how serious this is to each individual country; sensitivity dependence and vulnerability dependence. In 2.2 I introduce other factors that can influence and are influenced by the dependence relation. In 2.3 I look at the different ways that this can be translated into political outcomes.

2.1 Conceptualizing Economic Interdependence

First it is necessary to clarify what is meant by the term economic interdependence in this thesis, as it has been used in a myriad of different meanings in scholarly work (Baldwin 1980, Cooper 1985)⁸. This will be done in the following, by reviewing some of the relevant literature of the field before reaching the conceptualization used in this thesis. Hirschman was one of the first who viewed trade relations on the basis of a dependency perspective with his 1945 book *National Power and the Structure of Foreign Trade*. His book is still among the most influential in current debates about dependence on trade. Keohane and Nye's build on the work of Hirschman with their *Power and Interdependence*, and provide the most influential conceptual discussion of interdependence in a broader sense. Both books provide key insights, and will therefore serve as the starting point for the theoretical discussion.

2.1.1 Dependence following Hirschman

In this part I will use Hirschman's (1980) notion of dependence as a starting point, and argue that there are three factors that determines who is most dependent on whom in a bilateral economic

⁸ The terms dependence, dependency, interdependence, co-dependence and a range of other synonyms have all been used to describe what I have termed economic interdependence in this thesis.

relationship: (1) the total net gains which they receive from trade within the dyad, (2) whether the commodities traded are considered critical or non-critical and (3) the alternative markets and sources of supply that are available to both parties.

In the introduction I wrote that interdependence refers to a situation characterized by reciprocal (but not necessarily symmetrical) costly effects of transactions among countries or among actors in different countries (Keohane and Nye 2012:7-8). In economic dependence this implies separating analytically between situations. There has to be *significant* costly effects for there to be economic interdependence, in the sense that to do without the economic transactions would be of significant cost to the country involved. If there are no significant costly effects there is only interconnectedness. Making such an analytical distinction has some very important implications that I return to in part 2.1.2 below.

Hirschman makes no such distinction explicitly. He traces his own notion of dependence from economic relations back to Adam Smith. In *An Inquiry into the Nature and Causes of the Wealth of Nations* Smith acknowledged that exchange relationships involved benefits that satisfied mutual needs and which would therefore be costly to forego; giving rise to dependence. Hirschman elaborates on this in relation to trade:

The total gain from trade for any country is indeed nothing but another expression of the total impoverishment which would be inflicted upon it by a stoppage of trade. In this sense the classical concept, gain from trade, and the power concept, dependence on trade, now being studied are seen to be merely two aspects of the same phenomenon (Hirschman1980: 18).

The gain in the form of export revenue and imports of needed supplies is also what gives rise to dependence. But the dependence of two states on each other is not necessarily the same; one side might need the other more than vice versa. Keohane and Nye later distinguished between asymmetrical and symmetrical interdependence to describe this; but it is clear that Hirschman also believes that this is what gives one party power over another in a dependence relationship. Hirschman writes that: ‘If A wants to increase its hold on B, C, D, etc., it must create a situation in which these countries would do *anything* in order to retain their foreign trade with A’ [Emphasis in original] (Hirschman 1980:17)⁹. It is implicit here that country A is itself not equally dependent.

⁹ Hirschman notes that such a situation does not need to be the result of deliberate strategies on the part of the states involved.

Such a situation arises according to Hirschman ‘when it is extremely difficult and onerous for these countries: 1) to dispense entirely with the trade they conduct with A, or 2) to replace A as a market and source of supply with other countries (Hirschman 1980:17). From Hirschman’s analysis it is possible to draw out three factors that determine the relative economic dependence of the two parties on one another. That is, (1) the relative share that the bilateral trade represents for the two countries, (2) whether the commodities traded are critical or non-critical, and (3) the alternative markets and sources of supply that are available to the states.

First, one has to look at the relative share that the bilateral trade represents in the two countries total trade. In *National Power and the Structure of Foreign Trade* Hirschman’s looks primarily at a situation where trade between two countries represent a very small portion of one country's total trade, while it constitutes a major proportion of the counterparty’s total trade. This could be the case for instance where trade takes place between a large country and a small country or a rich country and a poor country (Hirschman 1980:30). According to Hirschman such a relationship can potentially give the larger economy coercive power over the smaller, because an interruption of the relationship could cause much greater distress in the smaller economy. His classic example is that of Nazi Germany vis-à-vis Eastern Europe in the interwar period (Hirschman 1980). In a self-critical article Hirschman (1978) later made some amendments to this, criticizing his younger self for taking a too structural approach. He acknowledged that because the trade represented a smaller share of the larger state’s total trade it would also pay less attention to it, thus creating an opportunity for the smaller state to escape the relationship – lower level officials deal with the relationship. This is the point where the works I have found (Reilly 2012a; Manicom and O’Neil 2010; Ross 2006) stop the theoretical exploration and draw out the ‘predictions’ of the theory: That the smaller economy (Australia), being more dependent, should accommodate the larger economy (China). This might be a sufficient indicator in some cases, but in other cases it will be insufficient. In the case under investigation I suspect it is insufficient. Furthermore it might be unreasonable to use the dichotomy of ‘small’ and ‘large’ economy in this case, as the Australian economy is among the 20 largest economies in the world.

It is also necessary to distinguish between critical and non-critical goods. Hirschman does not go into great detail, but he clearly states that some commodities are more important than others, labeling this the ‘supply effect’ (Hirschman 1980: 14, 20, 24, 34, 36, 39, 47). Hveem and Malnes (1980) made this distinction clearer with their focus on ‘strategic resources’; imported resources that are needed to supply the military, industrial and essential civilian needs of a country. Access to oil, coal, natural gas, minerals and some other raw materials has at times been a very relevant

issue of dependence. This has been the focus of much attention in the political economy literature (Hveem and Malnes 1980; Maull 1984), but has seldom been reflected in studies measuring economic interdependence (Blanchard and Ripsman 1996). However, such raw materials have been the focus of the recent energy- and resources security literature (in Australia best represented by Wilson 2011a; 2011b; 2012; Beeson Soko and Yong 2011; Leaver and Ungerer 2010; Ravenhill 2013a; 2013b). Resource security I defined in the introduction as the continuous availability of needed resource inputs at reasonable prices (UNDP 2000:112). For the exporter of such resources this could constitute a valuable political asset as it can counter the leverage of the importer; the importers threat of cutting off trade would have very little credibility if it at the same time shot itself in the foot economically (and/or politically) by doing so.

Reilly (2012b) acknowledges that this is a limit to Chinese economic leverage when he analyzes Beijing's recent trade sanctions on Philippine bananas in a dispute over Scarborough Shoal, a cluster of coral reefs and islets in the South China Sea. Agriculture makes up about a fifth of the Philippines economy and employs one-third of the population. Bananas are its second-largest export article, and nearly half of all Philippines' banana exports are exported to China. The restrictions quickly spurred fruit exporters to pressure their government to resolve the dispute (Higgins 2012). Reilly (2012b:130-131) notes that:

Beijing also could have limited consumer electronics imports, which make up 61 percent of all Philippine exports to China, or minerals (sixteen percent of all merchandise exports); however, it did not (...) Beijing sought to avoid damaging the broader economic relationship.

Third, whether such a difference in market size actually constitutes a power resource is also dependent on whether there exist alternative markets or sources of supply for the different commodities. A market that contains many supplier and consumer countries for a good presents states with a highly competitive environment, neutralizing the reliance of states upon each other to maintain their economic ties. In other goods there might be fewer buyers or sellers. Hirschman puts special emphasis on instances where there has developed a monopsony market structure, meaning many countries providing the same commodities and few buyers. Then the importer can potentially wield a great deal of power over the exporters, as it can easily switch to another source. Hirschman argues that this was the case for Germany vis-à-vis Eastern Europe in the interwar period (Hirschman, 1980: 34-40). Conversely, if the market structure is monopolistic

with few supplier countries and many buyers, it is the exporter who has the most power as it can choose between many possible outlets for its products¹⁰.

2.1.2 A qualitative distinction: sensitivity and vulnerability

In the following I point out that to understand the dependence on a nation-state level (and not in a relationship between two parties) one must draw a distinction between sensitivity and vulnerability. I argue that this distinction is a helpful tool when analyzing the results of the indicators above. After discussing the implications of such a distinction I propose a way to combine the sensitivity and vulnerability dimensions with the factors that have been outlined in 2.1.1.

So far I have followed Hirschman's approach and looked at how to assess who is most dependent on the counterpart in a dyad. For determining what this means at the individual country level there is much to be said for using Keohane and Nye's (2012:10-13) qualitative distinction between sensitivity and vulnerability; the latter being the most serious of the two¹¹. According to them an economy is sensitive to the extent that it is exposed to costs inflicted from the outside before policies are introduced to change the situation; it is vulnerable to the extent that it is exposed to costs inflicted from the outside after policies have been applied. If outside costs can be imposed on a country in the form of higher prices for a commodity that is of importance to its economy, say for instance oil, then that country is sensitive. If the country has some means to change this situation; either by switching their source of imports; by using trade sanctions in some way, by military force etc. then it is not vulnerable. If prices of these commodities go up and the country can do nothing about it then it is both sensitive and vulnerable. This distinction can be very useful when dealing with economic interdependence, but Keohane and Nye do not offer the best explanation of why that is so¹².

Both Cooper (1985) and Baldwin (1980) argue that we are dealing with two different theoretical concepts. Cooper provides the clearest distinction. According to him, sensitivity in economic dependence 'concerns how much adjustment a country has to make to 'foreign' events under

¹⁰ Note that Hirschman looks at market structures at the country level. Market structure at the firm level is introduced as a separate variable below.

¹¹ This distinction is also used in an earlier article by Kenneth Waltz 'The Myth of Interdependence'.

¹² One should note that the line between sensitivity and vulnerability is not clear cut (Crescenzi 2002:29). Barbieri (1995:71) for instance reduces them to one dimension; 'salience'; defined as the 'importance of the trading relationship, relative to other trading relationships'. By doing this she loses an analytical dimension; something that suits her purpose (measuring in a large n-study) but does not fit mine (understanding different mechanisms from economic interdependence to political outcomes).

conditions of normal economic activity', while vulnerability in economic dependence 'concerns how costly it would be to do without the transactions in question' after they have adapted to the new situation to the best of their ability (Cooper 1985:1197). Thus sensitivity dependence 'implies nothing about the cost of altering the relationship' (Baldwin 1980:477). Crescenzi (2002:28) goes one step further, claiming that: 'sensitivity interdependence involves the costs of being *in* an economic relationship with another country, while vulnerability interdependence refers to the costs of *getting out* of such a relationship' [emphasis added]¹³. Two things must be noted here. First, in addition to the meaning that Crescenzi puts in the word, vulnerability is often understood in a very specific context; the costs that would be imposed in a situation where there is a shortage of supplies to the point where it is uncertain whether this commodity can be supplied in needed quantities (see for instance Ravenhill 2013a; 2013b). In both meanings however, it is a question of costs imposed because of disruption of normal trade relations. Second, in my case a total severance of trade between Australia and China is unrealistic unless there was to be a major conflict between the US and China¹⁴. Therefore, and in line with Baldwin (1980:471) vulnerability also refers to interruptions in the relationship short of total severance.

Hveem (*forthcoming*), Crescenzi (2002), Cooper (1985) and Baldwin (1980) point the attention of political scientists to the vulnerability dependence concept as it is useful theoretically for understanding *how* trade can be used to gain political influence; namely through a threat of taking away some or all of the counterpart's gain from the trade relationship. As has been shown this was Hirschman's primary focus. However, I am not willing to define economic interdependence strictly in terms of vulnerability. A trade relationship as close as the one that has developed between Australia and China begs that both be taken into account. Previous studies (Reilly 2012a; Manicom and O'Neil 2010) and a lot of commentators seem not to have reflected too much about it. But as will be argued the distinction between sensitivity and vulnerability is a distinction that is very useful to understand the relationship between China and Australia in the period under study. This will be done below, but first it is necessary to narrow down the vulnerability concept.

A problem with Keohane and Nye's distinction between sensitivity and vulnerability in empirical work is that it makes it very hard to distinguish between cause and effect. If a country responds politically to higher prices for some commodity then the sensitivity dependence would be the cause and the political initiatives that follow would be the effect; but the political response is *also*

¹³ Baldwin prefers the term 'opportunity cost' over vulnerability, while Crescenzi (2002) introduces the term 'exit cost', but these terms refer to the same phenomenon.

¹⁴ Mearsheimer claims that this is inevitable, but I share the view of those who oppose him. See for instance Mearsheimer (2010).

what reveals how vulnerable that country is. Only over a period of time can we then determine whether that country is also vulnerable, by looking at how it responds. Vulnerability understood in this way is hard to measure in any meaningful way, and is certainly too wide for the purpose of this study. Following a stricter interpretation of economic vulnerability; that found in the works of Hirschman (1980)¹⁵, Baldwin (1980) and Crescenzi (2002); this thesis will instead look at vulnerability as the *economic costs* that would be imposed on both sides if trade in a given commodity was to be interrupted in some way.

Two of the indicators that have already been proposed in 2.1.1 are also relevant for determining the sensitivity dependence of the countries; namely share of trade and the types of commodity that are traded. This can be demonstrated quite easily through two examples. If a country's share of exports to another country is high, then the first country is sensitive to changes in demand in the second country. If a country imports commodities that are important to its industry then that country might be sensitive to changes in prices. However, price changes seldom stem from decisions made by a single trading partner. This will be discussed in further detail below. In order to determine the vulnerability of a country all three factors introduced in 2.1.1 can be important, but if the country has alternative markets of supply or exports, this factor is the most important one. If a country is sensitive to changes in demand from another country, that says little about whether the second country can choose to import the goods in question from a third country.

By doing this one can better understand the different causal paths from deepening trade and investment to political outcomes. It will be argued in section 2.3.1 that vulnerability in this sense when coupled with asymmetry that lends credibility to the most serious form of economic threats. Whether economic threats by political leaders are taken to be credible is what can *potentially* give the parties to the relationship political leverage. Both sensitivity and vulnerability can indicate what level of attention is paid by political leaders to the industries or sectors that suffer from it; and therefore it can also be a cause of political initiatives that seek to amend them.

2.1.3 *Summary*

In this section I have shown that there are three factors that one need take into account when assessing the symmetry or asymmetry in an economic dependence relationship: (1) the total net gains which they receive from trade within the dyad, (2) whether the commodities traded are considered critical or non-critical and (3) the alternative markets and sources of supply that are

¹⁵ Hirschman did not use this term, but his focus was on the costs in terms of lost market access and sources of supply. See quote on page 13.

available to both parties. Previous studies have not taken into account factor two and three. Because I am taking these factors into account, and because Australia does provide China with a range of raw materials (minerals and energy), I expect the economic interdependence relationship to be fairly symmetrical, where previous studies has expected that it is asymmetrical in China's favor. However, as reflected in the research question I also want to go one step further, and understand how the asymmetry or balance matters. I have provided a start with the distinction between sensitivity and vulnerability in this subchapter.

2.2 Dependence and Raw Materials

In part 2.1 two additional indicators were introduced when measuring economic dependence. I separated between critical and non-critical goods, and also introduced alternative markets and sources of supply on a country level. However, because some raw materials have been recurrent issues of dependence (Maull, 1985; Hveem 1978; Hveem and Malnes 1980), because particularly minerals and energy are a central part of the trade that takes place between China and Australia, and to be able to make a realistic assessment of the dependence relationship, it is necessary to elaborate a bit further on the specific nature of these kinds of raw material markets. Notice that I will also emphasize how the analytical tool introduced in 2.1.1, the distinction between sensitivity and vulnerability, can be applied in this context. In the second part of the subchapter I look briefly at some theory that will be useful to understand two of the conflicts that are directly related to the two parties' resource trade.

I argued above that Keohane and Nye's vulnerability concept proved too wide to measure in any meaningful way. However, it draws attention to something essential about dependence relations that Hirschman (1978) also acknowledged in his self-critical article; namely that they can change, and be changed, over time. In face of costs imposed from the outside under normal market conditions (sensitivity), or in the face of costs imposed as a result of disruption of normal trade relations (vulnerability), some countries can change the rules of the game.

2.2.1 Resource security: reliability and price

Hirschman (1980) set the bar too high when he sought to develop a universal theory for understanding dependence relations. Decision makers' perception of dependence on raw materials for instance has historically varied according to the geopolitical context of the time. When Hirschman wrote his book in 1945 he looked at the context of the Second World War. At

war major powers are naturally concerned about their supply lines being interrupted, or what has been defined as their vulnerability. Other periods have been characterized by a scarcity of supply in the face of rapidly increasing demand. In such periods major powers have often acted to secure their share of scarce resources or acted to bring onto market new resources (Hveem *forthcoming*).

In mineral markets there has never been scarcity in the sense of exhaustion. Rather, demand has fluctuated according to variations in economic growth rate and crises, while the supply has varied according to factors such as geological scarcity, costs of production, capacity problems or (lack of) exploration for new sites and innovation of new technologies (Hveem *forthcoming*). Consequently many markets have been characterized by a cyclical pattern: periods of oversupply followed by what Maull (1984) has branded ‘structural economic scarcity’, a result of underinvestment and rapidly rising demand. In hindsight his 1984 warning about mineral markets proved to be quite right:

Structural economic scarcities as the result of under-investment in mineral extraction and exploration could well occur during the next two decades; indeed, the steep recession of the early 1980s, with its depressing impact on mineral demand, makes such scarcity quite plausible (...) the implications of insufficient investment in mining industries could become acute if there were to be a sudden, unexpected surge in demand (Maull 1984:29-30).

As demand for a wide range of minerals and energy saw a sudden and unexpected increase, the supply of these commodities could barely keep up. In academic circles as well as in government circles there has been increasing attention on resource security (Ravenhill 2013b). Accompanying the issue of resource security in academic circles, the concept of ‘securitization’ has been used to describe the process where the supply of resources have gone from being perceived by governments as technical issues, a matter of economics, to being perceived by leaders as a matter of national security (Buzan, Wæver and Wilde 1998).

There are two main reasons for such attention that are inherent in the definition that has been given of resource security: one is the concern of prices of the commodities, and the other is the fear that there will not be enough resources to go around, making political leaders fear that the trade flow of important commodities is interrupted. The two are lumped together, so to speak, in the concepts of ‘resource security’ and ‘securitization’. In some commodities; say oil, natural gas, uranium and so forth; the concern might be more about securing enough supplies, or securing supplies from countries and regions that are considered reliable (so to make the chance of disruption as small as possible). If a country acts on such concerns it is trying to reduce its

vulnerability because it fears an interruption of its supply lines. The importing country can apply some means of controlling against being influenced in such a position: increasing domestic production, building stockpiles, increasing recycling, diversifying imports geographically, or technical substitution were another commodity can be used for the same purpose. However, there are limitations on all these measures (Hveem and Malnes 1980).

This was the concern that Hveem and Malnes (1980) addressed when they introduced a typology dividing suppliers into different categories of reliability. The political character of the supplier country, its political stability, and whether it is a strategic ally of the importer have historically been factors that make these countries more or less reliable. It is also a concern that some have brought up in relation to the Sino-Australian relationship. One Australian commentator claimed that China would not risk importing key commodities from Australia in the future because of the latter's alliance with the US (White 2011). However, despite their different political systems and alliances, it seems that Australia is perceived as a fairly reliable provider of resources.

In other commodities, say in iron ore, bauxite and copper, the concern might be less about securing sufficient quantities of supplies than with the price of those supplies, as high or volatile prices in these commodities might be detrimental to the importers domestic industries. Such concerns are related to the sensitivity dimension, earlier defined as how much adjustment a country has to make to 'foreign' events under conditions of normal economic activity. Note that governments of course can be concerned with both price and availability of the individual commodities; what is proposed here is that in some commodities the price issue is the biggest issue, while in others the physical availability is the biggest issue.

One reason for price increases during the 2000s is no doubt the rapidly rising demand from China and other emerging economies (Streifel 2009). But other factors can also contribute to the price that the importer has to pay. First, it is worth noting that in some commodities different suppliers may be cheaper than others. In bulk commodities like iron ore shipping costs is a factor that can have an impact on the price paid by the end user (Lee 2012:160).

2.2.2 Sensitivity, market structure and the role of multinational corporations

Two of the conflicts are related to the prices of a key commodity, namely iron ore. The first conflict is directly related to the pricing of that commodity, while the second is indirectly related to pricing through the concern that Chinese state owned enterprises (SOEs) might to some degree coordinate their investment decisions so as to manipulate the price of this commodity.

This section will offer a very brief theoretical background so that the conflict can be better understood. I will place special weight on how the market structure might theoretically be expected to affect the prices of some commodities, and how this is relevant in the Sino-Australian relationship. This is also meant as an empirical preview of what is to come later.

In some markets the supply- or demand side might be concentrated so that one side constitutes a monopoly, oligopoly or monopsony – not on the country level as was Hirschman's concern, but rather on the firm level. Wells (1993) argues that many mineral markets have had oligopolistic tendencies, with few but large multinational enterprises (MNEs) on the supplier side. Editor of Mining Weekly Chris Hinde has pointed out that although most mining corporations are 'price takers', a few large mining corporations are 'price makers' meaning that their market power mean that they are able to dictate prices (Arsenault 2011). That is of course also a question of how the production in the rest of the value chain is organized.

How production is organized along the (global) value chain, and how the different firms in the chain interact and coordinate the production can determine how power between the firms and hence value is distributed. Is production organized as a market with arm's length interactions and no explicit coordination, is it organized hierarchically so that the whole production process is integrated under the control of one firm, or is it somewhere in between? Gereffi et al. (2005:85) introduced a typology with these two as the extremes, and three intermediate forms: modular, relational and captive, with increasing degree of coordination and asymmetric market power from market to hierarchy. In the Asia Pacific steel production chain the steel makers have historically preferred captive type relations – in the 1960s for instance small and independent (and uncoordinated) Australian suppliers of iron ore were dependent on a coordinated Japanese import cartel, giving the latter greater bargaining power (Wilson 2011a).

For a country like Australia it might be advantageous to have price makers take care of the operation of its minerals exports. In the iron ore market BHP Billiton (BHPB) and Rio Tinto have had a strong market position in later years. Strong bargaining power in mineral prices on their part means high economic rents for the Australian government at the federal and state level (Huang and Austin 2012:166). However, this is contrary to the Chinese buyers' interest. In recent years China has been perceived as a key player in the distribution of market power in mineral markets, because of its monopoly position in the production and exports of rare earth elements (REEs), and because of a close relationship between the Chinese state and Chinese companies operating in mineral markets (Hveem *forthcoming*). But the Chinese often hold the opposite view:

in some market they are the biggest buyer, their industries are sensitive to rising prices, and yet they have been frustrated with an inability to influence them (Uren 2012:220).

Chinese SOEs on a quest for resources – state actors?

FDI differs from short-term portfolio investments as it implies a long term commitment in another country. In contrast to portfolio investments the goal is not only to earn a profit, but also to exercise some degree of control over the investment object (Claes et al. 2012: 159). The most widely used theory for explaining global FDI patterns is Dunning's eclectic paradigm (Dunning 2001), which states that there are three main reasons why firms would make FDI: 1) MNEs can possess ownership advantages, 2) countries can possess location advantages, and 3) MNEs can see advantages of internalizing the production rather than producing through a partnership arrangement (for instance a joint venture).

In later years China has increased its share of world outbound foreign direct investment (FDI). Between 2002 and 2012 Chinese outward FDI flows has grown on average 49.9 per year, reaching US\$ 68.81 billion. China's increasing outbound FDI has attracted much attention from scholarly circles, the media and Western leaders, perhaps mostly because of the large share of FDI that is held by China's State owned enterprises (SOEs) (Lan, Hveem and Luo *forthcoming*).

SOEs are nothing new, and not particular to China. In 2010 more than 40 per cent of SOEs operating transnationally were European (Hveem et al. 2011: 2-3). However, SOEs are quite diverse, and particularly the degree of state control varies; from those that function more or less like commercial enterprises to those that are under total national control. Chinese leaders often argue that their SOEs belong to the first group, while Western leaders often take the view that they also have other goals beyond profit. They point to the fact that many of the chief executive officers (CEO) of Chinese SOEs are also high ranking members of Chinese Communist Party (CCP), and that the SOEs often have favorable access to cheap loans from state banks (Ibid:5). The reception of Chinese companies investing in Western companies has therefore been lukewarm – the SOEs are perceived to have strategic goals as well as commercial ones on behalf of their home government (Beattie, Kirchgaessner and Minder 2008). Though the view that some hold of a 'China Inc.' seems very unrealistic, to what degree they for instance coordinate their actions is an open question.

Australia has been one of the top recipients of Chinese FDI in later years, especially in its resources sector (Drysdale 2011). The best way to ensure that economic rent that is associated

with resources is kept within a country's borders is to prevent foreign ownership of these resources. But for a country like Australia, where foreign investment historically has been the driving force in the mining sector, the question has never been whether or not to allow foreign ownership, but rather how to regulate it (Huang and Austin 2012: 4-5, 165-166). A sudden rush of FDI from China in 2008-2009 presented new challenges to Australia's liberal investment regime. Would they let Chinese SOEs internalize their production chains in Australia and gain increased control of the country's resource sector? I return to this in chapter 5.

2.2.3 Summary

In this section I first elaborated on the specific nature of mineral and energy markets, showed the resurgence in interest for the issue of resource security, and applied the distinction between sensitivity and vulnerability in this context. Second, I introduced some theory that is used to better understand two of the economic conflicts in the analysis.

2.3 From Dependence to Political Leverage

A line of criticism that can be directed against Hirschman (1980) and Keohane and Nye (2011) is that they did not explicitly go into how asymmetric economic interdependence translates into political leverage, leaving much to the imagination of the reader. In this section I will establish possible mechanisms through which dependence might be casually be linked to political leverage. As I will argue there are two main ways that one can theoretically expect this to happen, and these two are interlinked: (1) By economic pressure in combination with (2) pressure on the government from vested interests that have developed because of trade with the counterpart. I distinguished between two forms of economic pressure: 1) economic pressure that involves economic ties that are already in place, and 2) economic pressure involving taking future business opportunities elsewhere. Economic pressure will be treated in 2.3.1 and vested interests in 2.3.2. In 2.3.3 I discuss the theoretical possibility that if both parties are highly dependent on each other, they might over time 'learn' from past exchanges and seek to avoid actions that would demand a response from the counterpart.

2.3.1 Economic pressure

In the following I will use Wagner's (1988) critique of Hirschman as the starting point for theoretical discussion. I introduce 'economic pressure' as a possible mechanism linking the

balance or asymmetry of the relationship to political leverage in a dyad, and argue that it is meaningful to separate between two forms of economic pressure. Then, I argue that one it is essential to also somehow grade the interests of each party.

In the introduction political leverage was defined as the ability to make the counterpart do something that it does not perceive to be in its interest. The perhaps weakest point of both the analysis of Hirschman (1980) and Keohane and Nye (2011) is that they do not specify how asymmetry translates into political leverage. Keohane and Nye acknowledge that power measured in terms of resources or potential may look different from the actual political leverage, or the power measured in terms of influence over outcomes (Keohane and Nye 2012:16). The most powerful critique is offered by Wagner (1988), who alleges that while the arguments of Hirschman and Keohane and Nye seem highly intuitive, they suffer from several key flaws. His main thrust is against Keohane and Nye's argument that economic asymmetry cannot be used as leverage in a bargaining situation. This argument is compelling, but will not be discussed here¹⁶. Instead the focus will be on Wagner's main objections towards Hirschman.

Following Hirschman (1980) an asymmetric economic interdependence relationship between two countries might give the least dependent country political leverage over its more dependent counterpart because an interruption of the relationship in some form would cause greater distress in the counterpart's economy. This is supposed to happen through implicit or explicit threats of interruption, or in the last instance by actual interruption of economic ties. The term 'economic pressure' will be used in this thesis to describe this mechanism. Economic pressure can be defined as 'efforts at coercive or threatening economic behavior by an initiating government directed against a target government' (Tanner 2007:12), and includes deliberate disruption or threat of disruption of normal trade or other economic relations.

Wagner (1988) points out that Hirschman's argument suffers from 'the Blackmailer's Fallacy'; the belief that if a nation A would rather give in to a demand by another nation B than suffer some form of punishment, then it is possible for nation B to successfully extract this demand by merely threatening nation A with the punishment. This ignores the cost to the sender of going through with the threatened punishment; making a threat that it cannot enforce. He is partly right in this critique. Sanctions or other forms of economic pressure involving the interruption of trade are costly to the country that imposes them; how costly depends on the factors that are outlined in section 2.2. However, in a situation where the costs are deemed to be significantly lower than the

¹⁶ Crescenzi (2002) offers a good counter-critique, albeit one that is less relevant in my case.

domestic political costs of refraining from using such sanctions then they can be viewed by a government as justifiable (Baldwin 1985). This is especially relevant in the case of China. Fuchs and Klann for instance (2010:7) find that China's political leadership is willing to bear the economic costs that arise from diverting trade away from countries receiving the Dalai Lama, and argue that this is because they think this increases the likelihood of their political survival. However, Fuchs and Kahn (2010) also note that there seems to be clear (economic) limits to what the Chinese leadership perceives as justifiable. This brings into clear focus that a government must be *willing* to risk some economic gains in order to gain something else.

Wagner (1988) also points out that an asymmetric dependence relationship tells us little about how highly the two value the outcome of the particular issue that is at stake; in particular how strong the interest of the receiving state is. Keohane and Nye for instance write that often 'the more dependent actor may be (or appear to be) more willing to suffer' (Keohane and Nye 2012:9). Willingness to suffer is hard to measure. This will be solved in this thesis by defining the interests of the two parties on the particular issues and indicate the strength of these.

Wagner underscores his point by citing the literature on trade sanctions (Wagner 1988:474). From much of this literature one gets the sense that economic pressure does not work, because the receiving country seldom changes its policies when sanctions are applied (Baldwin 1985). However, Hovi (2001) suggest that most of the literature on economic sanctions is overly pessimistic about the prospect of making the target country change its policies. This is because most of the statistical work on trade sanctions excludes negative cases, where the dispute between two countries has ended at the threat stage. Sanctions are most often threatened before they are imposed and they are carried out only if the receiving country does not comply with the demands. If a credible threat of sanction fails, this often signals that the receiving country does not intend to comply with the demands regardless of whether sanctions are imposed (Hovi 2001). For the sender of the threat to not lose credibility, it can be important nonetheless to go through with it. Drezner (2003) finds that the success rate is much higher when one also takes into account these negative cases.

The sanctions literature is in a sense a sidetrack. Threats are complex, and several factors will determine whether they will be successful or not (Hovi 1999). Surely, it would be better to be in a situation where the counterpart lacked the ability to act on any threat it might make, where the costs for the sender of going through with a threat would be economically quite large and the economic damage done to the receiving country quite small. As pointed out by Hovi (1999), the single most important factor for determining whether a threat is to be successful, be it an implicit

threat or an explicit threat, is whether that threat is perceived as credible by the receiver. If the economic costs of actually going through with a threat appear to be quite large, then one would expect that the threat appears less credible. Reflecting this, and keeping the essence of Hirschman's argument, it is meaningful to separate between different levels of economic pressure, and assess whether it is possible for the parties to the relationship to make credible threats of using them.

Economic pressure – It is time to conceptualize economic pressure as it will be understood in this thesis. I will differentiate between *two levels* of economic pressure. The most serious level is related to the vulnerability dimension as defined in 2.1.2. If one party is vulnerable to disruption of trade in some commodity and the other party is not, then the cost of interrupting trade in that commodity will be bigger for the party that is vulnerable. The less vulnerable party can threaten to cut off trade or apply sanctions in that commodity with large credibility, or it could in the last instance actually act on them without the costs of that being very high. This seems to be the kind of economic pressure that Hirschman (1980), Baldwin (1980) and Crescenzi (2002) have in mind – economic pressure that involves interrupting trade ties *that are already in place*, or threats of such interruption. A good example of this kind of economic pressure is that which China recently applied in relation to the Philippines: by stopping imports of bananas from the Philippines, China was able to apply huge pressure on the Philippines at relatively little cost. Another example might be China's export restrictions on REEs that are vital for a wide range of industrial purposes in Japan (Bradsher 2010), although the costs of this to China in hindsight were fairly large.

However, this kind of economic pressure might be less tempting if the costs of going through with them are high. In relation to resources markets that were described in 2.2 there are several things that need to be taken into account before making a threat. Obviously in some commodities, say natural gas and oil, the impact of a disruption of supply could be huge. In other commodities, say iron ore, if the threatening country's domestic industries are sensitive to price increases, then that country would have to take into account the cost in terms of additional price increases if it was to act on the threat. By going through with a threat one would probably force the price up. Furthermore, in both cases the result of punishing one country would be to up one's reliance on another. If it is a goal to diversify the imports of the particular raw material then it might not be a good idea to refrain from purchasing from individual supplier countries to punish them for their behavior.

The second and less serious level of economic pressure involves punishing other countries by taking *future business opportunities* elsewhere, or threatening to do so. This includes selective

purchases or non-purchases, banning some companies from participation in tenders, (government-directed) foreign direct investment strikes, variation in leadership visits (that are often accompanied by business delegations) and so on. The Chinese economy has long been hailed as the future market above all else; and the Chinese have also been trying to exert such economic pressure in other cases. A good example of this would be the economic pressure China applied on France in 2009. When it was announced that President Nicolas Sarkozy would meet the Dalai Lama, China postponed the EU-China summit, and froze an order for 150 Airbus planes. The French government views Airbus as important for the country's economy, and Airbus views China as the largest future market for its airplanes (Reilly 2012b:126).

However, in some mineral and energy markets even these kinds of threats can be regarded as too costly. If sensitivity to prices is a problem, then the factors that determine price need to be taken into account before going through with a threat. If one chooses to punish a country that is located relatively close by diversifying away from that country, then first off the larger shipping costs could add on to the price that the country is already paying. Furthermore, by diversifying away from that country you at the same time become more reliant on another country. In other commodities, say natural gas or oil, the alternatives may be less reliable. If a supplier country decides to interrupt trade flows, then that country will most likely be regarded as a less reliable source of imports in the future.

For both kinds of economic pressure, if the costs are relatively high, there is less chance that the threatening country will act on them, and the threat will probably also appear to be less credible to the receiving country.

The case of Australia and China – However, as these examples indicate there are not many governments that are willing to; nor *able* to; apply this kind of economic pressure on other governments. The ability to apply such pressure may be greater for economies where the state has a larger role in the economy than liberal economies (Morrow, Sivertson and Tabares 1998:1). First, it seems that China is to some degree able to use selective purchases, something that is carried out by its SOEs. Second, when threats have been applied in the past the Chinese government has often combined this with diplomatic pressure (Reilly 2012b). In summary:

the significant scope of government influence in the Chinese economy provides the country's political leaders with all means required to manage trade in such a way that it rewards countries that adhere to China's political preferences and punishes those that do not (Fuchs and Klann 2010:7)

It has already been pointed out that there is some uncertainty about how much control Beijing can exercise over its SOEs. This uncertainty might lend further credibility to Chinese economic threats. This is a factor that must be taken into account in addition to balance of the relationship.

China has long criticized the use of unilateral economic sanctions, particularly those used by the US. However, as their economy has grown stronger over the past decade it has been documented by several accounts that China's *willingness* to use economic pressure has increased in instances where it has had the ability to do so (Reilly 2012b), especially in cases where their perceived core interests have been threatened (Fuchs and Klann 2010; Tanner 2007). A challenge with regards to Chinese economic pressure for the purposes of this thesis is that, in contrast to the US, China rarely openly declares its use of for instance economic sanctions. Instead, Beijing has often used informal measures (Reilly 2012b). This means that the government's hands are clean – the leaders can deny that they have given any order. It also means that they can reverse these policies without announcing it publicly.

Australia on the other hand has more limited scope for using economic pressure to achieve foreign policy goals. As a 'middle power' Australia has an interest in a rule based regime of trade. Furthermore Australia has long taken a liberal approach to trade and investment, and the political debate revolves heavily around trade performance. It is highly unlikely that Australia would use trade as a means of coercion against China. Indeed, its status as a reliable supplier of certain key commodities is dependent on it abstaining from any such actions. The best case scenario for Australia would be for China not to use economic pressure.

2.3.2 *Vested and changing interests*

A less appreciated part of Hirschman's work is his emphasis on how national interests can change as a result of changes in trade patterns (Abdelala and Kirshsner 1999). Hirschman (1980) pays more attention to the use of trade as a means of coercion than to vested interests and influence, but he provides some examples (Hirschman 1980:18, 28, 29, 34, 37). Vested interests will according to Hirschman develop in all cases as some groups will necessarily gain from the trade. This is however more important when the difference in relative size of the two economies is large. According to Abdelala and Kirshner (1999:120) in such instances 'the effects are typically large, visible, and almost wholly found within the smaller economy'. This is because those who benefit from the relationship will be strengthened economically relative to those that do not. Therefore the first indicator given in 2.1.1, the relative size of the two economies should provide

a good indicator of the strength of such vested interests. The sectors that have most at stake in the relationship with China will also be expected to be most willing to lobby the government for Beijing's objectives. However, for this mechanism to take effect the business interests must stand something to lose – or at least perceive that they stand something to lose – by not convincing their government to accommodate Beijing's wishes.

Also, if the gains from trade are distributed unequally across a country, then it is possible that those regions of the country that gain the most and by definition also have most to lose can have different and at times conflicting interests with the government (Singer 1950). This is perhaps especially interesting in the federation of Australia, where the state of Western Australia accounts for a large portion of the trade with China.

This mechanism can of course be helpful for a country exerting economic pressure (as defined above) on another; intense pressure on the government from the exposed sectors or industries might help it change its mind about demands made. But it is reasonable to expect that the pressure that they put on their government will be most intense when there is a risk of cutting off already existing trade, and less intense if it involves future contracts. However, the business interest does not necessarily have to be uniform among different companies in every case.

Furthermore the business interest of the exposed industries is not necessarily the only influential group in a country: 'Governments are, after all, responsive to considerations other than aggregate gains from trade' (Bobrow, Reich and Chan 1998:191). Other domestic groups might also pressure the government, so that the government has to take different domestic interests into account (Putnam 1988). Given the issues of conflict in this case, it is reasonable to expect that there will be strong counterforces in democratic and economically liberal Australia and Western countries more generally, towards business interests lobbying for the interests of autocratic and economically quasi-mercantilist China.

2.3.3 Exchanging power?

The zero-sum approach to power that has been used so far has some limitations. Coleman (1974: 33-54) and Hernes (1975) introduce the notion that the power of one actor over another on one issue may be exchanged for power of the other actor over the former on another issue. If this happens, power is not a zero-sum game, as both parties increase their power over the other with respect to different or similar aspects of behavior simultaneously. These theoretical advances on the issue of power are reflected in Keohane and Nye's (2012) critique of realist assumptions. In

many instances realist assumptions are inadequate for analyzing real events; rather they describe an ideal type. The authors therefore construct an opposite ideal type, namely ‘complex interdependence’. Complex interdependence is characterized by a situation where non-state actors participate in world politics so that there are multiple channels of connection between societies; where military security does not dominate the agenda of government, rather there is an absence of hierarchy among issues and many issues arise as the direct result of internal politics; and where force is an ineffective instrument of foreign policy (Keohane and Nye, 2012: 20). Note that their theory does not reject realism, but only stresses that the dynamics of some parts of the world may be closer to the realist assumptions of world politics; others will be closer to the assumptions of complex interdependence.

The complex interdependence situation that Keohane and Nye (2012) envisage is one where the actors accept that other actors have power over them. It has been argued thus far that it is the asymmetric kind of economic interdependence that is the basis of one country to apply economic pressure on another in a bilateral relationship, and that such economic pressure (coupled with vested interests) may translate into political leverage. This is especially so if one party is vulnerable while the other is not, because in such instances it can apply the most serious form of economic pressure at relatively low cost. However, if both parties are vulnerable the costs to both parties of this kind of behavior could be immense. It is possible that over time they both realize that they have such power over the counterpart, and thus in a process similar to that envisaged by Coleman (1974) and Hynes (1975) ‘agree’ to abstain from such behavior. In relation to China and Australia, if both parties are vulnerable it is a theoretical possibility that they will ‘learn’ from their past exchanges and thus agree to abstain from actions that would demand a response from the counterpart, and extend their line of communication to decrease the potential for misinterpretation of the counterpart’s intentions and so that when issues do arise they can be handled at an initial stage (Hveem, *forthcoming*).

2.3.4 *Summary*

In this section I have briefly reviewed some of the criticism against Hirschman’s argument that asymmetric dependence can translate into political leverage by threats of interruption, or interruption of economic ties. I introduced the mechanism of economic pressure, but noted that it is important to take into consideration the cost of actually going through with the threat to the sender in addition to the costs of the recipient of such a threat. I have argued that it is necessary to define the two parties’ interests and indicate the strength of them. Although it is unreasonable

to expect a 1:1 relationship between economic asymmetry and political leverage, it was argued that the best position to be in is a situation where the counterparty lacks the ability to act on any threats that it might make. I distinguished between two forms of economic pressure: 1) economic pressure that involves economic ties that are already in place, and 2) economic pressure involving taking future business opportunities elsewhere. It was argued that the first one was much more serious than the first one. For both kinds of economic pressure, if the costs are relatively high, there is less chance that the threatening country will act on them, and the threat will probably also appear to be less credible to the receiving country. For China it was argued that the state's role in the economy and its willingness in recent years to use economic pressure can be factors that those on the other side of the table take into account when they assess the credibility of a threat.

I also introduced a third mechanism, namely vested interests. This is only relevant in the smallest country when the difference in size of the two economies is large. The sectors that have the most at stake in the trade relationship are also expected to lobby most intensively. One can also expect a similar effect with regards to different regions of the country if the gains from trade are distributed unequally across these regions. However, in Western countries one might expect there to be strong counterforces to attempts at lobbying over China. The chapter ended in an open-ended argument: if the relationship is fairly balanced and both parties are vulnerable, they might over time 'learn' from past exchanges and seek to avoid actions that would demand a response from the counterpart.

3 Method of Inquiry

In this chapter I will discuss the method of inquiry; what the goal of the research is and the methodological decisions that have been made to draw valid inferences from the analysis. In section 3.1 I will shortly define the goal of the research; in section 3.2 I will present the research design, the causal model and operationalize the variables that have been discussed in chapter 2; in section 3.3 I will elaborate on the choice of research design and case selection; and in section 3.4 I will discuss methodological challenges that I have encountered in my study.

3.1 Goal of the Research

This research project has one empirical and one theoretical goal. Theoretically, the goal of the research project is to explore the causal mechanisms between economic dependence and political leverage in a bilateral political relationship. To obtain this goal I seek to use dependence theory with an emphasis on the (asymmetric) interdependence case. Empirically, the goal is to explore how the increased economic interdependence has affected each side's political leverage in the Sino-Australian relationship.

3.2 Research Design

There is no such thing as a perfect design; every research design has its strength and weaknesses (Gerring 2007:38). Reflecting this, the research design must be carefully selected so that the strengths of the design are complementary to the goals of the research. To achieve my goals, I have chosen a case study. The case is limited to the time period of 2000-2013, thus focusing on the period where the trade between the countries grows the most. I also limit the case to four areas where their interests have been contrary because the two sides' interaction in these areas can reveal whether one side has had to compromise its interests more than the other, and also *why* they compromise their interests. The four areas that have been chosen have already been mentioned but I will repeat them here: 1) the pricing of iron ore, 2) Australia's investment regime (these two conflicts are partly connected to each other, and will be treated in one subchapter), 3) defense policy and 4) human rights.

I use the case study method for two main reasons. First, the case study scores high on internal validity and therefore suitable for my goal to uncover causal mechanisms between explaining factors (Gerring 2007:43; George and Bennett 2005:19-21). I want to understand *the processes*

through which asymmetric economic interdependence turns into political leverage, where previous works have been mostly occupied with arguing back and forth about how best to measure ‘strategic alignment’ based on the theoretical ‘prediction’ outlined on page x. Second, uncovering causal mechanisms at the level that I am seeking require a depth of study only accessible through a case study. I seek to say something about motivations, perceptions and internal processes in a bilateral political relationship. The emphasis on depth has provided a deeper insight in this respect, which would be lost with extension to more cases (Gerring 2007:48-50).

Though not belonging in this tradition entirely, the research design is inspired by the ‘process tracing’ approach (Mahoney 2002:363; Checkel 2005; George and Bennett 2005:6-7; Gerring 2007:180, 185). By *triangulation*, cross-checking a wide range of qualitatively different sources; I seek to understand certain important events and the motives of actors that took part in them (Tansey 2007:673). I make use of trade and investment data to measure the economic dependence of the two parties on each other. A wide range of sources are used to map the historical period in the four areas, including academic and journalistic books on the subject, newspaper articles and elite interviews. The elite interviews were conducted some way into the research process to corroborate the early findings (Ibid). The use of multiple sources has strengthened the inferences drawn in the analysis. More about this follows in section 3.5.

The thesis is part of the project *The Political Economy of Global Mineral Markets*. The project studies change and continuity in the distribution of market power in the most important global mineral markets, in particular metals and rare earth elements (REEs). It addresses a widespread current belief that markets have radically changed due primarily to globalization and to the advance of the BRICS and other emerging economies, in particular China. The Australia-China case has been selected because of its relevance for the project.

3.2.1 Causal model

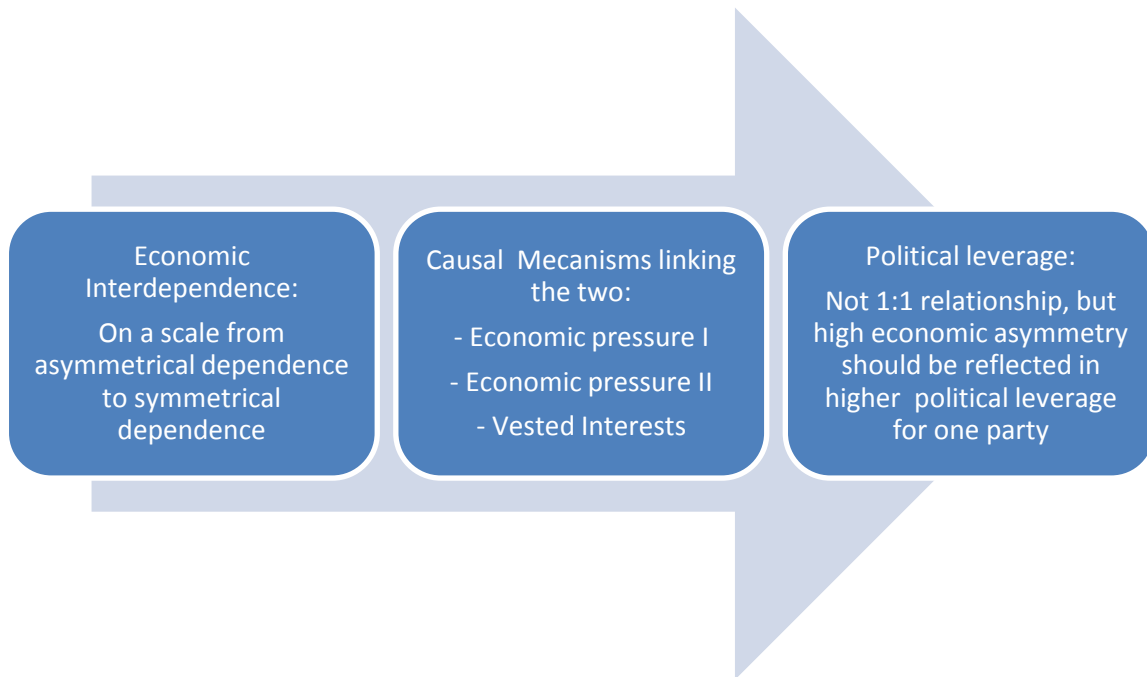
In this part I will briefly describe the causal model that will be used in this thesis. I will operate with two main variables, (1) economic interdependence on one side, and (2) political leverage on the other side. The economic interdependence variable is the one defined in the theoretical chapter, and consists of three factors. When evaluating how this translates into political leverage (or not), I use the distinction between sensitivity and vulnerability to interpret the economic interdependence factors, while also taking into account the broader factors outlined in 2.2. This

can give a good picture of the ability of the actors to apply economic pressure in the two forms outlined in 2.3. Because there is a clear qualitative difference between the two, I treat them as separate mechanisms, labeling them economic pressure I and economic pressure II. In addition I have included vested interests as a third mechanism. However, this mechanism can be expected to take effect only when the firms, industrial sectors or federal states in question feel that they stand something to lose by failing to act. This mechanism therefore works in tandem with the two forms of economic pressure.

I assume that the economic interdependence variable varies on a scale from symmetrical to asymmetrical interdependence. If the economic interdependence is symmetrical, then both parties are equally dependent upon each other. If the economic interdependence is asymmetrical, then one country is very dependent, while the other country is not. From the theory one can expect that symmetrical economic dependence in most cases will lead to symmetrical balance in each side's political leverage over the counterpart. That is, no side can force the other party to do something that goes against its perceived interest. If, on the other hand the dependency relationship is asymmetrical, with one party clearly more dependent, then the least dependent party *could* use this to seek political leverage, and more clearly force the counterpart to accept agreements against its will. As reflected in the theory I do not expect there to be a 1:1 relationship between economic asymmetry and political leverage. Nonetheless if the economic interdependence relationship is asymmetric, then this should be reflected in higher political leverage for the less dependent part. More on how I will measure the two variables follows in 3.3.

The distinction between sensitivity and vulnerability is used analytically to understand the nature of each country's dependence, and is not included in the model. Three main causal mechanisms link economic asymmetry and political leverage. I described these three causal mechanisms in the theoretical framework, but to sum them up quickly, they are the following: economic pressure I, economic pressure II, and vested interests. These causal mechanisms explain how a certain value in interdependence will lead to a similar; but not necessarily equal; value in political leverage. The figure underneath is a simplified description of the causal model that has been established so far.

Figure 1: Causal model.



3.2.2 Operationalization of key concepts

Measurement validity is a prerequisite of internal validity. The operationalization of the concepts must capture the meaning assigned to the concepts in the theory section in order to draw valid inferences (Adcock and Collier 2001). In this section I will show how the main concepts are operationalized. The sensitivity-vulnerability distinction will not be treated here as it has already been treated extensively in the theory, and will serve only as an analytical tool.

Economic interdependence – As outlined in section 2.1 the economic interdependence variable has three components. The first component will be measured by looking at the share of each country's export that is sent to the counterpart. In the case of Australia, where the export flows represent a fairly large share of its total, other indicators will also be used to get a clear picture of how its economy has changed over the 2000s. First, the sectors and commodities that have increased their share of the economy will be assessed. These industries contribution to the Australian economy in terms of export revenue, contribution to GDP and employment will be indicated. It is hard to calculate the latter two, so it will to some degree be necessary to rely on the calculations of others here. The second component will be assessed by looking at the type of products that the two countries import from each other. Are they easily replaceable luxury goods,

or are they critical inputs to their economies? In the case of China, who imports a range of minerals and energy products, I will also look at China's dependency ratio of these commodities. How big a share is produced domestically, and how much needs to be imported (Hveem and Malnes 1980)? In addition to domestic production and imports, this indicator should ideally also include the country's exports of the same material, numbers for recycling and numbers of available stocks. However, these data are not available. The third component will be assessed by looking at the alternative markets and sources of supply available to each country. This will not be done in every single commodity, but rather the most important ones. Besides calculating how much of the total annual consumption for these commodity that comes from the relevant trade partner, it is also necessary to evaluate the alternative sources of imports and markets for exports that are available. This will be done by looking at which other countries offer alternatives.

Market structure – In addition to looking at the number of export countries, capacity of alternative sources and opportunities for diversification of imports from other countries in the economic interdependence variable, I will also look at market structures on the firm level. This is especially important in the iron ore market, where there has been conflict due to the pricing of the product, the market structure itself, and Chinese investments in the Australian iron ore sector that can be viewed partly as an attempt to alter the market structure.

Political Leverage – As mentioned in the introduction, the term political leverage is here understood as the ability to make the counterpart do something that it does not perceive to be in its interest. This definition is, as mentioned, similar to a broadly accepted definition of power as an actor's ability (1) to pursue autonomous policies and (2) to get other actors to do something they would not otherwise do, at an acceptable cost. By interests I mean the perceived interests of the governments, and not interests measured in a completely objective way. To measure each side's political leverage, one needs to find policy areas where there is strong disagreement, and therefore potential for one part to force the other into taking a course that is not in its interest. In policy areas where there is conflict one will often find which party has power over the other. Four conflicting policy areas have been chosen, because of the continuous disagreement between the states on these: (1) prices, (2) investment, (3) defense policies and (4) human rights issues. I will evaluate these three policy areas over the time scope of 2000-2013. In short, each of these three is treated in 6.1 (prices and investment), 6.2 and 6.3 respectively. Each sub-chapter starts out by mapping the perceived interests of the two parties in each policy area, and then goes on to analyze which country gets its way in the conflicts arising. This measure is a qualitative measure, and not possible to quantify in any meaningful way. In 6.4 the findings in the three areas will be

discussed while at the same time drawing on the views of the respondents to see if their views correspond with mine.

Economic pressure I – Economic pressure was defined in the theory to have two levels. The first and most serious level is the kind of economic pressure that involves interrupting trade ties that are already in place. In the chapter 5 I will assess the ability of the two states to apply this kind of pressure based on the vulnerability of each state as defined in the theory. Then, when looking at the three policy areas in chapter 6, I look for instances where threats of for instance trade sanctions have been applied, and how credible these have seemed to the counterpart. One problem here is that there might be threats that are not made public, and that therefore will not be included here. This can to some degree be corrected by some of the respondents. The ability of each state to use such economic pressure will be a subject of discussion in 6.5, and the respondents' views will be given much weight here.

Economic pressure II – This type of economic pressure is less serious than the first one, and involves punishing other countries by taking future business opportunities elsewhere, or threatening to do so. Since this kind of economic pressure should have lower cost to the sender than the first kind of pressure and because China often in the past has punished other countries without telling them first, for this mechanism it will be necessary to look for whether China actually prioritizes to award contracts and such to other countries. This can be quite hard to assess. However, one can expect large and important contracts to be made a policy issue in Australia and addressed in the media. One can also read something out of the trade and investment data – are there any abrupt shifts that may indicate that one side was able to punish the other?

Vested interests – The third kind of mechanism is vested interests. The vested interests as I have defined them in the theory are no more than the sectors in Australia that benefit particularly much from increasing economic transactions with China and are thus likely to work to defend Chinese interests in political decision-making processes. When some sectors increase their importance to the overall economy, it is reasonable to assume that these will also gain greater political influence.

What I am trying to find out in the analysis is whether these interests have tried to exert influence over government policy towards China, whether the interests are unidirectional or divergent and whether other political forces have greater influence and 'counterbalances' the vested interests. When analyzing the vested interests I take a holistic view, and make use of already established

research on lobbying in Australia, news coverage, domestic opinion polls on the issues, and information provided by the respondents.

3.2.3 Generalization

Using the case study method of course greatly limits the ability to make generalizations. This is however not the purpose of this study. I analyze this case in order to search for limited regularities, to identify relatively general issues that take place in comparable historical contexts. Several mechanisms I specify can be useful to other cases of the same type, under certain conditions (Bryman 2004:273-275). The relatively general issues identified in this case can especially be useful in other western countries that have increased their trade with China in the 2000s. Many of the same mechanisms described here might be present in other countries.

This thesis is meant to contribute to Helge Hveems research project *The Political Economy of Global Mineral Markets*, and in that way it is only a 'building block study' in a larger search for answers on raw materials trade and dependency (George, Bennett 2005:75-78). The study might provide a stepping stone to get closer to generalizations based on a larger number of cases.

3.3 Collection of Data and Methodological Challenges

In this section I will briefly go through the data that have been used, explain how I selected the respondents for the thesis and why the semi-structured approach was chosen for these interviews, and lastly discuss some methodological challenges briefly.

In the first part of the research the goal was to assess the economic dependence of the two countries on each other. For this purpose a range of statistical data on trade, investment and other economic indicators have been used. These data have been collected from various sources. The Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) and the Bureau of Resources and Energy Economics (BREE) of Australia publish statistics on Australia and other countries resource trade, the Department of Foreign Affairs and Trade in Australia (DFAT) publish more general trade data sorted by commodities. Regarding China's consumption of key minerals, I have not been able to find numbers for recycling of different minerals, or the numbers for China's domestic stocks of these minerals. This problem is a minor one, however, and will be of little significance for the conclusions of this thesis.

The second part of the research required first of all a mapping of the historical period under study. This was done first and foremost through secondary literature such as academic articles, books on the subject; but also primary sources like government white papers and Hansard material covering debates in the Australian Parliament. The third part of the research process was one month of field work in Australia, interviewing various key elites in Canberra, Perth and Sydney. For the Chinese side of the story this thesis has had to rely on secondary sources. This is first of all because of limited time and resources, but also because news articles and government papers are written in Mandarin. However, there are several good books and articles about Chinese resource policy both written by western China experts and native Chinese in English.

In some cases government cables supplied by Wikileaks have been used. These cables have already been referred to extensively in the press both in Australia and elsewhere, and in the academic literature. It must be emphasized that these cables may be taken out of context and are not entirely accurate; especially in instances where U.S. officials have paraphrased what has been said or added their own opinions on the matters. The Australian government and the companies involved have refused to comment further on the material. This will be taken into account, but by cross-checking with other sources they can be viewed as useful pieces in the puzzle.

3.3.1 Picking respondents for the interviews

According to Aberbach and Rockman (2002:673) 'In a case study, respondents are selected on the basis of what they might know to help the investigator fill in pieces of a puzzle or confirm the proper alignment of pieces already in place'. This has been the criteria used when selecting respondents in the research process. Respondents were picked to elucidate the research question, confirm or debunk my initial views of how they perceived Australia's dependence on China, and my initial views of particular key events that had taken place over the period in question. In short, the interviews were meant to 'contribute towards the research goal of triangulation, where collected data is cross-checked through multiple sources to increase the robustness of the findings' (Tansey 2007:6).

The purpose has therefore not been to attain a representative sample *per se*, but rather to single out key informants that could help me gain a clearer understanding. I have targeted key 'elites', the leaders and representatives of various stake-holding organizations, and politicians of the four biggest Australian political parties. As expected (Goldstein 2002), getting in contact with such respondents and finding an appropriate time and place did prove challenging, as their schedules

were tight. However, once the first interviews were confirmed and completed, it was easier to get new interviews as some of the respondents took it upon themselves to help me get in contact with others on the list, also known as the ‘snowball effect’ (Tansey 2007:18). A list of the 15 respondents that I managed to get in contact with, the title and experience that made it relevant to see them and the time and place that the interviews were conducted, can be viewed in the appendix.

I wanted to meet with one Senator from each party, and the individual Senators were selected on the basis of their experience in different committees and/or work with specific inquiries. I ended up interviewing three Senators representing the Australian Labor Party (Labor), the Liberal Party of Australia (the Liberals) and the National Party of Australia (the Nationals), as well as the economics adviser to the Australian Greens (the Greens). In addition I interviewed four senior government officials, two lower-ranking government officials, three former top level diplomats with experience from dealings with China, one Minister at the State level, one representative of the biggest mining union in Australia, and two academics. These were all selected on the basis of their experience. Their key experiences are quite diverse and can be viewed in the appendix. I cite their title and experience where relevant in the text.

One cannot take everything the respondents have to say at face value, as they might have their own agenda or motives (Berry 2002:680). The information given to me by the respondents was cross-checked with the other sources, as outlined above. With that said, some of the reflections of the interviews have been quite helpful in assessing the dependence relationship, and I intentionally leave room for the respondents to express longer arguments to give the reader a clear picture of how they perceive the dependence relationship.

3.3.2 Semi-structured interviews

According to Aberbach and Rockman (2002), elites (and other highly educated people) often respond best to questions that are not close-ended, so that they get the chance to fully articulate their responses. But the ‘unstructured’ approach with just a topic of conversation does not fit when we want more specific information. I therefore selected semi-structured interviews. For this strategy to be successful it is important to first make a good interview guide (Leech, 2002: 665-666). I made several interview guides as I wanted to know different things from different people. I used the same interview guide in my interviews with the Senators. This consisted of three broad categories of questions (see appendix): the first category consisted of broader, preliminary

questions about the respondents' views on the relationship, the second category consisted of questions regarding how China in their view differed from Australia's other main trading partners, and the third section consisted of questions about the significance of the mining industry to Australia and whether the domestic politics of raw materials had changed over the last ten years. I made the respondents aware before the interview started that these were the three themes that I wanted to cover, but the order of the questions varied from interview to interview. If the respondents for instance made interesting arguments or provided information that I was not aware of, I would pursue these by asking follow-up questions. For the other respondents I made similar guides, with different topics of discussion. In these interviews I was often looking for more specific information related to their experience, so the interview guides for these necessarily had to be quite diverse.

With some respondents I had very limited time. One respondent only had ten minutes to spare, so that I had to single it down to the most important questions. However, most of the respondents took the time to answer all my questions. In two of the interviews I was not allowed to record, and these were used only as background. Furthermore, one respondent said that he could not speak on behalf of the organization that he currently worked for (the Department of Resources, Energy and Tourism), the organization that he had previously worked for (The government of Western Australia), but that he could give me his opinions and thoughts from his own experience in these positions.

3.3.3 Methodological challenges

The central methodological challenge in this thesis has been to understand how the two parties think about their economic dependence, and how it translates to political leverage. The indicators that have been used in the economic interdependence variable as it has been defined in this thesis are not necessarily how central decision-makers think about dependence. Key players will have an impression about the dependence, but they will not necessarily know all the economic data that I draw on in chapter 5. I have tried to make up for this to some extent by getting the views of some centrally placed bureaucrats and politicians, and by triangulation on a range of other sources.

4 The Economic Interdependence Relationship

Having established the theoretical and methodological framework for this thesis, it is time to establish the relationship of dependence in the central period of the study; 2000-2013. In this chapter the dependence of the two parties on each other will be reviewed in two steps. In 5.1 I use the three indicators that I introduced in the theoretical part (2.1.1) to assess whether the economic dependence relationship is balanced or asymmetric. Based on these indicators I conclude that the economic interdependence relationship is fairly symmetric. In 5.2 I use the analytical distinction between sensitivity and vulnerability to interpret what this and other factors mean for each individual country. The goal of the chapter is in short (1) to establish who is most dependent on whom in the economic relationship and (2) to highlight the nuances and differences in each party's dependence.

4.1 The Balance in the Dependence Relationship

In this section I will use the indicators that were developed in chapter two and three: (1) the total net gains which they receive from trade within the dyad, (2) whether the commodities traded are considered critical or non-critical and (3) the alternative markets and sources of supply that are available to both parties.

A brief look at the overall trade and investment relationship is a good place to start. According to Chinese statistics the two countries bilateral trade in merchandise increased nine fold from 2002 to 2010, from US\$ 10.435 billion in 2002 to 88.090 billion US\$ in 2010. Australia has benefitted most from their trade in later years in terms of export volumes, and has developed a large trade surplus of US\$ 33.640 billion with China (Sen 2012:106)¹⁷. They have also greatly expanded their services trade to a total of AU\$ 7.112 billion in 2010, and Australia has developed a sizeable surplus of AU\$ 3.869 billion (DFAT 2011). Most of this can be explained by increasing numbers of Chinese students coming to Australia (DFAT 2012b:2).

China is now the biggest market for both exports of services and merchandise, and the trade surplus that Australia has developed both in exports of merchandise and services are the biggest that Australia has recorded with any country.

¹⁷ Note that the Australian statistics are slightly different and gives Australia a smaller trade surplus. These numbers therefore do not correspond with the numbers in the rest of the chapter. The reason is that the two countries use different statistical methods: China's customs use the Cost, Insurance and Freight (CIF) basis while Australia uses the Free On Board (FOB) basis when calculating these numbers (Sen 2012:113).

4.1.1 *Dependence on the China as a market for exports*

However, these numbers are not a good indicator of the relative dependence of the two countries on the bilateral trade. In the following I will assess the dependence of the two on each other as markets for exports.

As shown in table 3 below China has accounted for a very large part of Australia's total exports for most of the period; reaching 27.2 per cent of Australia's total merchandise exports in 2011. Recent figures for the period 2011-2012 give China an even larger share, 28.9 per cent of total exports of Australian merchandise (DFAT 2012c). In addition China was one of the most important sources of imports, reaching 18.1 per cent in 2011-2012. As China is a much larger economy the equivalent numbers for China are much lower. In 2011-2012 Australia accounted for 1.8 per cent of China's total exports and 4.7 per cent of its total imports (DFAT 2012c).

Table 1: Australia's relative dependence on bilateral merchandise trade with China (million AU\$)

Year	Merchandise exports to China	Merchandise exports total	Share of total exports that goes to China
2006	20 375	165 342	12.3 %
2007	23 792	169 747	14.0 %
2008	32 337	224 365	14.4 %
2009	42 526	197 232	21.6 %
2010	58 421	232 346	25.1 %
2011	71 451	263 151	27.2 %

(Source: DFAT 2012a)

It will be shown in more detail in 5.2 that especially Australia's increasing dependence on China as an export market means that changes in the Chinese economy will have economic ramifications in Australia. There has indeed been a structural shift in Australia's economy over the last decade making it more complimentary to China's economy (Wesley 2012:199-201). An indicator of this is Australia's composition of exports. Natural resources have been an important part of Australia's exports portfolio for the entire period. But during the period there was a significant shift in the composition of Australia's total exports towards resources that to a large degree must be credited to China (also to some degree South Korea, Japan and India) (DFAT 2012a).

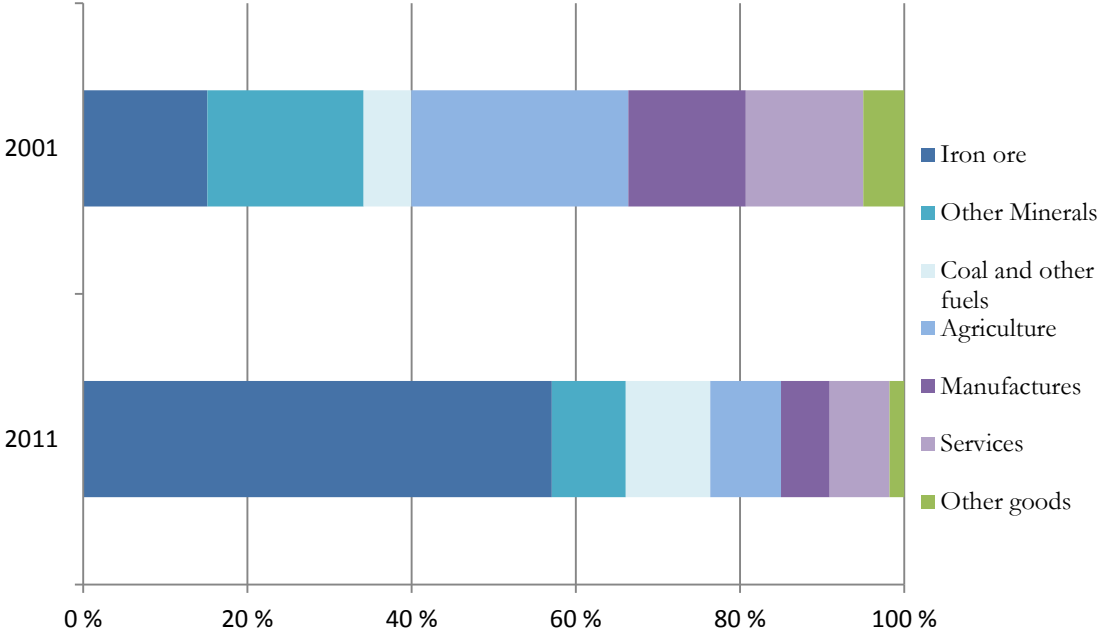
Natural resources have taken on much greater significance in the two countries bilateral trade, accounting for 76.3 per cent of total trade in 2011 compared to 40 per cent in 2001¹⁸. Particularly iron ore has made up a larger and larger share of the exports to China, as illustrated in figure x

¹⁸ Excluding gold, which makes up most of the 'other goods' category.

below. In 2001 iron ore exports made up 15.1 per cent of the total trade with China; in 2011 it made up 57.6 per cent of Australia’s exports to China (DFAT 2012a). The category ‘minerals’ constituted 66 per cent of Australia’s total exports to China in 2011.

Largely because of Chinese demand Australia has become a world leading producer of a range of minerals. Over the period China has become Australia’s most important market for iron ore, bauxite, copper, nickel, zinc, manganese and a major importer of nearly all other Australian minerals. China is becoming an increasingly important market for natural gas and coking coal (although China’s share of Australia’s total coal exports is still minor compared to that of Japan and South Korea, as I will return to).

Figure 2: Composition of Australia’s exports to China 2001 and 2011.



(Source: DFAT 2012b)

Furthermore coal and other fuels have become increasingly important during the period, largely as a result of large demand for coking coal in China (see table 5 below), but also because of a significant increase in sales of crude petroleum and LNG (DFAT 2012a).

But the most striking thing is that one commodity, namely iron ore, has such a huge impact on the total trade relationship. Table 4 below shows that iron ore alone accounted for some 61.5 per cent of all merchandise exports to China in 2011, and the iron ore exports to China that year accounted for 16.7 per cent of Australia’s *total* merchandise exports.

Table 2: Australia's iron ore exports to China as a percentage of total merchandise exports to China and total merchandise exports.

Year	Exports of iron ore and concentrates to China (AU\$)	Total merchandise exports to China (AU\$)	Iron ore exports as % of total merchandise exports to China	Iron ore exports to China as a % of total merchandise exports
2006	7,627,492	20,374,893	37.4 %	-
2007	9,023,521	23,791,919	37.9 %	5.3 %
2008	17,931,980	32,336,719	55.5 %	8 %
2009	21,790,196	42,525,783	51.2 %	11 %
2010	34,685,103	58,421,274	59.4 %	14.9 %
2011	43,970,009	71,462,750	61.5 %	16.7 %

(Source: DFAT 2012a)

Coal also made up a large part of the overall trade relationship starting in 2009, when the Chinese started importing coal in larger quantities. In terms of value there was more than a tenfold increase of Australian coal exports to China from 2008 to 2009.

Table 3: Coal exports as a percentage of total trade with China.

Year	Exports of coal (AU\$)	Total merchandise exports to China (AU\$)	% of total merchandise exports to China
2006	598,838	20,374,893	2.9 %
2007	382,235	23,791,919	1.6 %
2008	508,278	32,336,719	1.5 %
2009	5,650,977	42,525,783	13.3 %
2010	5,191,343	58,421,274	8.9 %
2011	4,543,053	71,462,750	6.4 %

Source: DFAT (2011a)

These two are the ingredients that go into China's steel industry¹⁹. No other industry in any country has had the same impact on Australia's total trade balance. However, with regards to many of these minerals it is important to note that while Australia has greatly expanded their production in terms of volume, the price leaps for many of them have also been very favorable (Dou 2012:133).

Minerals and energy are not equally large contributors to GDP and employment, but they have become more important over the decade. Mining accounted for some 4 per cent of Australia's GDP in 2010/2011. Direct employment in Australian mining accounted for only about 2 per cent of total employment in Australia in 2011, and there was created about 130 000 new jobs in mining from 2001 to 2011 (BREE 2012a:18). Resource-extraction more generally (including energy) accounted for some 3.25 percent of employment. However, according to the Reserve

¹⁹ Note though that this category consists of both coking coal (which is needed for the production of steel) and thermal coal.

Bank of Australia, if one also includes jobs in resource-related construction and other industries that in some way have gained from the resources boom then this share is larger. The broader resource economy accounts for about 9.75 percent of total employment (Rayner and Bishop 2013). Especially in the resource states, like Western Australia, high levels of investment and employment in the mining and construction industries has meant large increases in employment (BREE 2012a:19).

It would be hard to calculate how much of this could be attributed to China. One report estimated that exports to China generated 4.6 per cent of GDP in 2010 (Stewart Partners 2011). It is widely recognized that China's stimulus package after the financial crisis of 2008 was part of the reason why Australia as the only advanced economy recorded GDP growth in 2009 (2.1 per cent) (Ravenhill 2011:37)²⁰. This was acknowledged by the Treasury in its 2010 *Economic Outlook*:

Australia has largely avoided the business failures and large-scale employment losses that have occurred in many other countries, providing a solid foundation for the recovery. The positive outlook is being increasingly underpinned by an improved global outlook and by our close trade links to the rapidly growing Asian region, and in particular China (Treasury 2010: 2–3).

The mining sector contracted more than the economy as a whole during the initial phases of the crisis (Ravenhill 2011:38), but throughout 2009 China's package was starting to take effect in mineral markets. While Australia's total exports contracted by 9.8 per cent in 2009, exports to China increased 29 per cent (DFAT 2010i: 1, 5). Exports of coal had been negligible before but increased tenfold from 2008 to 2009, and iron ore exports increased by 45.2 per cent.

Investment

The two countries' investment relationship is not as mature as their trade relationship. Chinese investment in Australia has grown fast, increasing 81 times between 2003 and 2009, and then decreased in the following years. Even so neither of the two countries account for a particularly large share of the counterpart's total foreign investment (Sen 2012:107). It should be noted that while Australia's investment is spread across a diverse set of industries, China's investment is concentrated in the resources sector. Particularly in the iron ore mining industry China has invested heavily. After the financial crisis investment from China took on a more significant role in Australia, as FDI inflows from the rest of the world dropped by 20 per cent (Drysdale and

²⁰ Australia's two stimulus packages must also be given credit. Especially the government's cash injections in the period before China stimulus package had taken effect in raw material markets (Ravenhill 2011).

Findlay 2009:354). Even so British, American, Japanese and South Korean enterprises are still the dominant owners in this sector (Huang and Austin 2012:72).

4.1.2 Easily replaceable and critical goods

In this section the relative importance of the commodities traded will be assessed. I will show that China is much more dependent on Australia as a source of imports than the other way around, even though Australia accounts for a much smaller share of Chinese imports. This is because China imports raw materials that are critically important to their own domestic industries. China is particularly dependent on imports of iron ore, given the (real and perceived) importance of the steel industry to its domestic economy.

As noted above China has become Australia’s largest source of imports, with 18.1 per cent of total imports in 2011-2012. Major imports from China include clothing, communications equipment, computers, toys, games and sporting goods, furniture and televisions (DFAT 2011:171-172). Imported Chinese merchandise holds a large proportion of the Australian market, and their low prices have had a considerable inflationary impact on the prices of goods in Australia that should not be underestimated. Combined with the high prices of several raw materials, Australia’s terms of trade have reached record levels over the last decade (Dou 2012). However, the point that should be noted here is that most of these goods are relatively easy to replace (Sen 2012:113). China’s Asian neighbors offer plenty of substitutes, although there would be a cost of doing this as the substitutes would be more expensive.

China imports mostly resource products that are hard to replace; where China is becoming increasingly dependent on foreign imports. Table 7 below shows how China has become increasingly reliant on foreign supplies of different key minerals.

Table 4: China’s import dependency rate for selected minerals

Mineral	Bauxite	Copper	Iron ore	Manganese	Nickel
1970	33	65	0	s.n.s	s.n.s.
2005	43	79	55	100	70

(Source: Hveem *forthcoming*)

Table 8 below shows China’s dependency ratio in iron ore over the past three decades. From the available data we can see that domestic production of iron ore has not been able to keep up in the 2000s. As a result China’s dependency ratio has been high, above 50 per cent since 2003.

Table 5: China's dependence on iron ore imports 2000-2009

Year	Domestic production (mt)	Consumption (mt)	Imports (mt)	Exports	Dependency ratio
1985-89	61.8	73.3	11.5	n/a	15.7%
1990-94	101.7	127.4	25.7	-	20.2%
1995-99	126.7	176.1	49.4	-	28.1%
2000	111.3	181.3	70.0	-	38.6%
2001	108.5	200.8	92.3	-	46.0%
2002	116.3	227.8	111.5	-	48.9%
2003	131.4	279.4	148.1	-	53.0%
2004	155.7	363.8	208.1	-	57.2%
2005	210.3	485.6	275.3	-	56.7%
2006	298.6	624.9	326.3	-	52.2%
2007	353.7	736.8	383.1	-	52.0%
2008	390.1	833.7	443.6	-	53.2%
2009	442.3	1070.0	627.8	-	58.7%

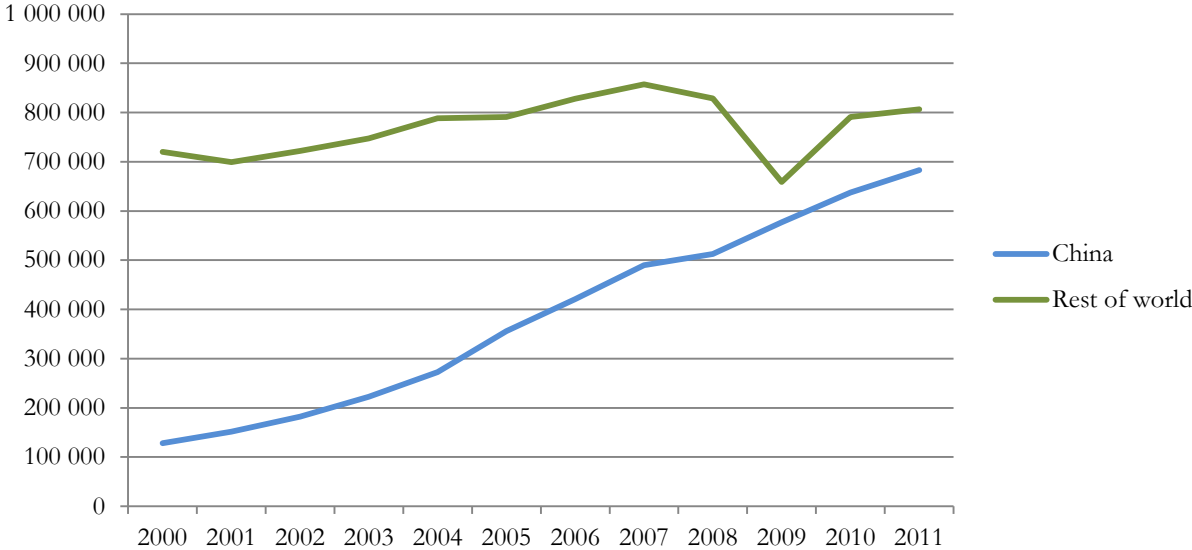
(Source: Wilson 2011a:254)

Many of these resources are critically important to sustain China's export- and investment-led growth. The metal minerals serve as input in China's metal processing industries. The metals produced are particularly important in manufacturing and construction. These have been the primary drivers of Chinese growth over the last decade (Roberts and Rush 2010:2012). Given that the 'performance legitimacy' of the Chinese government is almost entirely dependent on its ability to keep the process of economic development going (Beeson et al, 2011), the continuous supply of these raw materials (at reasonable prices) is of critical importance.

Building housing and infrastructure such as roads, railways, sewerage systems and electricity generation and distribution systems have generated sharply higher demand for metals such as copper, aluminum and steel over the past two decades. In addition long-term investments in manufacturing capacity and infrastructure, and the manufacturing boom that followed China's acceptance into the WTO, have also contributed to growing Chinese metals demand (Coates and Luu 2012:12-13). The most important sectors for aluminum consumption are machinery, electronics and transport (particularly in the production of cars). Copper is mainly used in electronic products, engineering, construction and car-production. Other base metals like zinc and nickel have a range of industrial uses in both the construction and manufacturing sectors (Roberts and Rush 2010: 9-10). And after the financial crisis reduced external demand for Chinese products, Beijing launched a large investment package in domestic infrastructure that made demand for iron, steel and other materials jump (Coates and Luu 2012:14). It is important to keep in mind that it was this package that kept the Chinese growth high in the troubling years after 2008.

Given the importance of iron ore especially and to a lesser degree coal in the trading relationship the Chinese steel industry demands a closer look. Figure 2 below shows that China’s steel industry has dramatically expanded its output over the past decade, from 128 500 mtpa in 2000 to 683 265 mtpa in 2011; increasing its share of world output from about 15 per cent in 2000 to about 46 per cent in 2011. The Chinese steel industry was responsible for nearly all growth in world steel production in the 2000s.

Figure 3: Annual Steel Production 2000-2012 (mtpa), China and rest of the world.



(Source: World Steel Association 2010; 2011; 2012)

China’s steel industry has long been, and still is, viewed as a symbol of national strength. In the views of many Chinese leaders the steel industry ‘lays a solid foundation for China to establish a complete industrial system and promote the development of various sectors of the national economy’ (Zhang 2012:2). There are several reasons why Chinese authorities consider the steel industry a key industry to the economy at large (Tang 2010:1), has labeled it one of several ‘strategic’ industries, and maintained tighter control of this industry than for other industries (Wilson 2011a:97-98).

Importing the large amounts of the steel that China has needed in its period of rapid industrialization (1978 to present) would take a very heavy toll on China’s trade balance. This was a lesson that the leadership learnt after Deng Xiaoping’s 1978 industrialization program started to take effect. Steel consumption increased drastically while the domestic industry was not able to expand its production, and imports surged from 11 percent to 35 percent of consumption from

1980 to 1985 (Wilson 2011:245). The dependence on imported steel thus became ‘one of the important factors restricting the development of the national economy’ (Howell et al. 1988:366).

The enormous expansion in production of steel during the 2000s closely reflects China’s consumption of the same material throughout the decade, although steel production has been somewhat higher than consumption in later years (KPMG 2011:2). Steel products are irreplaceable in almost all economic sectors, including housing and infrastructure, machinery, automobiles, household appliances, shipbuilding, light industry, energy and transportation; among which the building housing and infrastructure is especially steel intensive. Indeed, its perceived importance and multifunctional qualities is reflected in its Chinese nickname: the ‘food of other industries’ (Zhang 2012:2). The table below shows the most important sectors for steel consumption (the category ‘construction’ includes infrastructure).

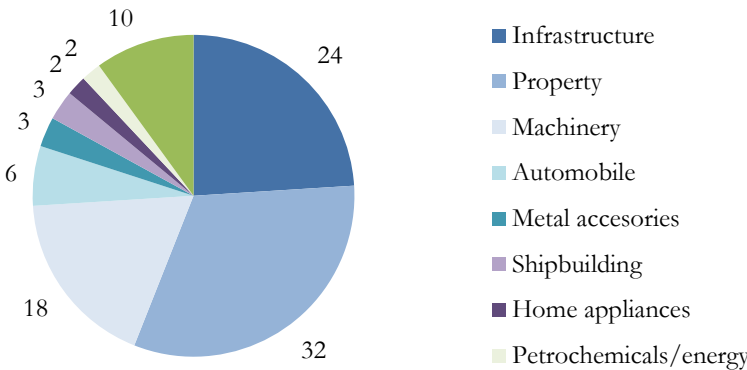
Table 6: Chinese steel consumption by industry, selected years.

Per cent of total steel consumption, selected years			
	2001	2005	2008
Construction	57	55	54
Machinery	15	12	18
Automobile	6	5	6
Home Appliance	3	2	2
Rail, shipping and fuel	5	5	5
Other	15	21	15

(Source: Roberts and Rush 2012)

Below is a more detailed breakdown of China’s steel consumption for 2010, showing the proportion that goes into infrastructure, housing and the other industrial categories.

Figure 4: China's steel consumption by sector.



(Source: KPMG 2011:4)

Furthermore the industry itself makes an important contribution to GDP. Among the 39 industrial categories of China the iron and steel industry was ranked in third and second place respectively in 2010 (Zhang 2012). For these reasons Chinese authorities has an interest in the success of its metal processing industries, and particularly its steel industry, making the metal minerals of critical importance.

In addition China's energy needs have expanded rapidly over the past decade, making Beijing highly focused on the country's energy security: 'China must search continuously for solutions to its problem of rising energy demand' (Jian 2011:1). China's imports of natural gas have expanded from 27.2 billion cubic meters (bcm) in 2000 to 96.8 bcm in 2010. However, China only started importing natural gas in significant volumes in 2006, and became a net importer in 2007. Domestic production still accounts for about 90 per cent of its natural gas needs. The remainder is provided both through pipelines and liquefied natural gas (LNG). Australia is a big supplier of the latter (IEA 2012). Uranium is also an important part of Beijing's energy security strategy. China's consumption of uranium has increased rapidly during the 2000s, and the government has announced that it intends to raise the share of nuclear power from 1.1 percent of the total energy demand in 2013 to 6 percent in 2020 (Basov 2013). Australia started supplying China with uranium in 2008 after Australian Prime Minister John Howard and Prime Minister Wen Jiabao had concluded a deal in 2006 (Perlez 2006; Medcalf 2011:5). While this commodity represents only a tiny fraction of the trade relationship in terms of value – about AU\$60 million in 2011 (DFAT 2012b:4) – it is unquestionably a commodity that is viewed as strategically important because of its use in nuclear weapons (Medcalf 2011).

4.1.3 Alternative markets and sources of supply

As shown Australia's import dependence on China is clearly lower than the other way around. Merchandise from China does hold a large proportion of the Australian market, but the labor-intensive products that it exports to Australia can easily be replaced (although the replacements would more expensive). The commodities that China imports on the other hand are (with good reason) viewed as critical to sustain China's growth. In this section I will assess the alternatives of the two parties in some selected key raw materials. This will be done by first giving an overview of (1) Australia's share in the Chinese market for these key commodities and (2) China's share of Australia's exports for these same commodities. The situation in the market of the raw materials that are *most important* in the trade relationship will then be treated here.

For Australia we can see that in copper, zinc, manganese and nickel China a high percentage of the total production is exported to China. However, it is also clear that these raw materials do not constitute a very large part of Australia's total exports. On the Chinese side of the equation Australia does not hold a large share of China's total. In copper, the most important mineral by value, Chile and Peru are much larger producers and exporters than Australia. China's imports are more diversified in this commodity, with Chile (24 percent), Peru (16 percent), and Australia (11 percent) as the biggest suppliers (Hammer and Jones 2012).

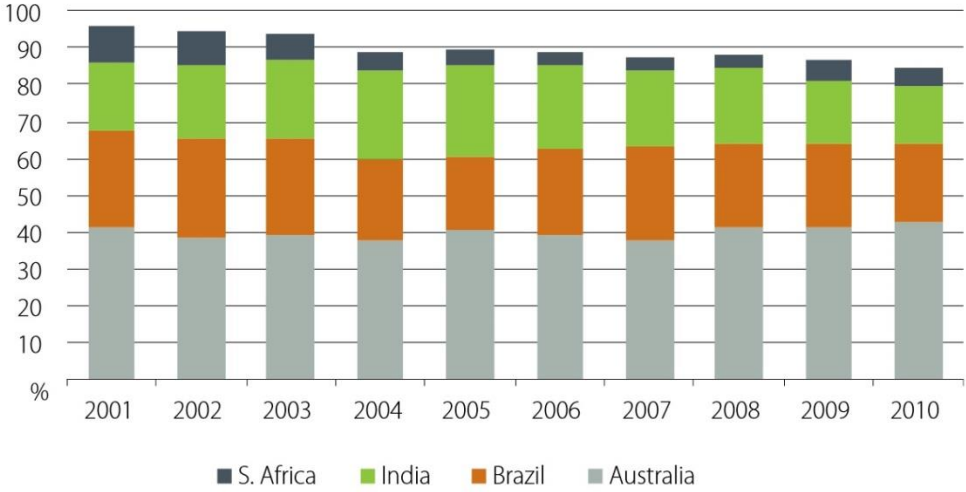
Table 7: Australia's top mineral exports to China 2011 (not including gold, exports to China worth 1284 million AU\$ in 2011).

Commodity	Commodity's % share of all export commodities	Value Exported to China (AU\$ million)	% exported to China
Iron ore and concentrates	24.5	43,970	68.7
Coal	17.9	4,543.1	9.7
Copper ores and concentrates	2.1	1,500.9	27.6
Copper	1.5	1,203.0	31.3
Zinc ores and concentrates	0.6	607.0	41.5
Manganese ores and concentrates	0.5	841.2	61.3
Zinc	0.4	243.3	25.1
Nickel	0.2	257.4	39.8
LNG*	-	\$US630	-

(Source: DFAT 2012a; *LNG in Murdoch 2013)

Iron ore – China's share of Australia's exports of iron ore has risen rapidly during the 2000s, accounting for 68.7 per cent of Australian total iron ore exports in 2010–11. The flipside is that as shown below, Australia's has supplied around 40 per cent of China's iron ore needs for most of the decade. So although Australia has become highly dependent on China as an export market for iron ore China itself has been highly dependent on Australia as a source of this commodity. China itself has plenty of iron ore, but it is of low quality, and expensive to mine (Coates and Luu 2012:15). Brazil is the major competitor with 311mt in 2010, while India (96mt) and South Africa (48mt) came in as number three and four respectively. There are few alternatives as of yet on the seaborne market (see table in the appendix).

Figure 3: China’s imports of iron ore from South Africa, India, Brazil and Australia.



(Source: BREE 2012a:81)

New projects that are currently being developed in West and Central Africa might offer alternatives in the future, but currently they cannot match any of these four countries’ production (Hurst 2012).

Coal – Coking coal is a different story on both sides of the trade relationship. Although Australia is one of the world’s largest producers of both coking coal and thermal coal (BREE 2012a:48) the major export markets are South Korea and Japan (DFAT 2012a:13). Furthermore China’s import dependence is low in both kinds of coal. For the period under study China has been largely self-reliant. It should be noted that this might change in the future; as shown Australia’s coal exports to China started to really take off in 2009, and Chinese analysts have expressed particular worry about increasing dependence on coking coal, with some fearing that it might turn into ‘the next iron ore’ (Beeson, Soko and Young 2012:1368). In 2009 China imported 36 million tons of coking coal; while the domestic coking coal production was about 700 million tons. China’s domestic coal reserves are very large and of good quality (Wilson 2011a:243-244).

LNG – Coal has long been the dominant energy source in China, accounting for some 70 per cent of energy demand in 2009, but as noted Chinese authorities aims to ensure that natural gas will account for 10 percent of energy consumption by 2020. China only started importing natural gas in large quantities in 2006, and became a net importer in 2007. China started importing LNG from Australia in 2006, as a result of a 25-year supply deal that was struck in 2002. The deal was worth US 13 billion dollars, and was to that date the biggest single export order that Australia had ever gotten. That is, until in 2009, when a new US 50 billion long-term LNG contract was signed

with the Chinese (Priestley 2010). Exports have expanded rapidly since. China buys the bulk of its LNG under multi-year contracts from Indonesia, Malaysia, Qatar and Australia. Australia is currently the largest supplier, providing some 30 percent of China's total LNG imports in 2011, followed by Qatar (19 percent), Indonesia (16 percent) and Malaysia (13 percent) (IEA 2012).

4.1.4 Summary

In this section I have looked at the three indicators that were outlined in the theory. Australia is more dependent on China as a source of export revenue. Neither is particularly dependent on the other as a source of investment although China has invested heavily in Australia's resource a source of investment in its iron ore industry. However, in terms of import dependence China is more dependent on Australian commodities than the other way around. Australian natural resources are critically important for China to sustain its growth. Australia exports a wide range of minerals that China needs, although the former is not largest supplier of all these goods. It is noteworthy that China especially has few alternatives to Australian iron ore. The economic dependence relationship is therefore fairly balanced, following what has been argued in 2.1.1.

4.2 Interpreting the Results

Having looked at the most important indicators, in this subchapter I will use the theoretical distinction between sensitivity and vulnerability to highlight the nuances in each party's dependence. The interpretations made in this part will be important for understanding the mechanisms at work in the conflicts between the two countries governments. I treat the two countries separately in the first two sections starting with Australia in 4.2.1 and then China in 4.2.2, and sum up the implications of this for the mechanisms that have been suggested in the theory in section 4.2.3. The third mechanism that has been suggested, vested interests, will be treated in 4.2.1 because it is only relevant for Australia.

4.2.1 Australia's sensitivity and vulnerability

In this section I will look at the implications of Australia's increasing sensitivity to the Chinese economy, and argue that there is no direct connection between the Australian economy's sensitivity to changes in the Chinese economy; i.e. costs under normal economic conditions; and China's ability to use economic pressure against Australia. I point out that in one commodity; iron ore; Australia is vulnerable in the sense that an interruption of trade relations in this

commodity would be detrimental to the Australian economy as a whole. For other minerals I argue that while Australia exports a large portion of the total of these to China they do not constitute a large part of Australia's economy. I also look specifically at the states and businesses that gain the most from the trade with China and therefore in line with what has been argued in 2.3.2 are most likely to lobby Canberra for China's interests.

Australia's sensitivity to the Chinese economy – The Australian economy is directly exposed to changes in the Chinese economy, and has become more so throughout the 2000s. As argued in 4.1.1 Chinese demand has become increasingly important in the context of the GFC. The increased exposure to the Chinese economy also has some downsides. As shown there have been large structural changes in the Australian economy, making the economy increasingly dependent on exports of minerals. For one thing the upwards pressure on the exchange rate has created problems for other export oriented sectors of the economy, making Australia a 'dual economy' (Zhang 2011:75). The more important point for the purpose of this thesis is that it exposes the Australian economy more directly to China. An economic slowdown in China is likely to have an adverse impact on the Australian economy. As noted by Reilly and Yuan (2012:8):

...the problems are easy to tick off: massive bad debt in the unreformed state-run banking sector (...), growing inflation, unemployment and underemployment, shrinking export markets abroad, a failure to shift to domestic consumption, and a looming real estate bubble of massive proportions.

Another way to phrase that is that 'anything that harms China's growth harms Australia's interests'²¹. Australia's sensitivity means that it has a bigger stake in the *continued success* of the Chinese economy.

Australia's vulnerability in iron ore – However, that does not necessarily mean that China has the ability to apply economic pressure on Australia. From the above sections it is fairly clear that there is one commodity that is particularly important for Australia in its trade relationship with China. Iron ore exports constituted 68.7 per cent of Australia's total merchandise exports to China and 16.7 percent of Australia's total merchandise exports in 2011. Following the argument made in 2.1.2 Australia is vulnerable to interruptions in this commodity, as an interruption would have a large effect on government revenue, Australia's trade balance and to a lesser degree on employment. But it has already been shown that for China this is a critical commodity, and that China has imported about 40 percent of this commodity from Australia throughout the whole period, meaning that China is equally vulnerable. Coal is also a very important export commodity

²¹ Interview with Geoff Raby, Ambassador to China 2007-2010.

for Australia, but less so in relation to China. Even though Australia exports a large part of the other minerals to China, these do not constitute a large enough part of the trade relationship individually to make a big impact. For LNG China is a market that has the potential to become large in the future, but under the period of study this commodity has not constituted a large share of the total trade.

Vested interests – A consequence of the structural shift in Australia’s economy towards resources is that the mining lobby has taken on increased significance in Australia’s domestic politics:

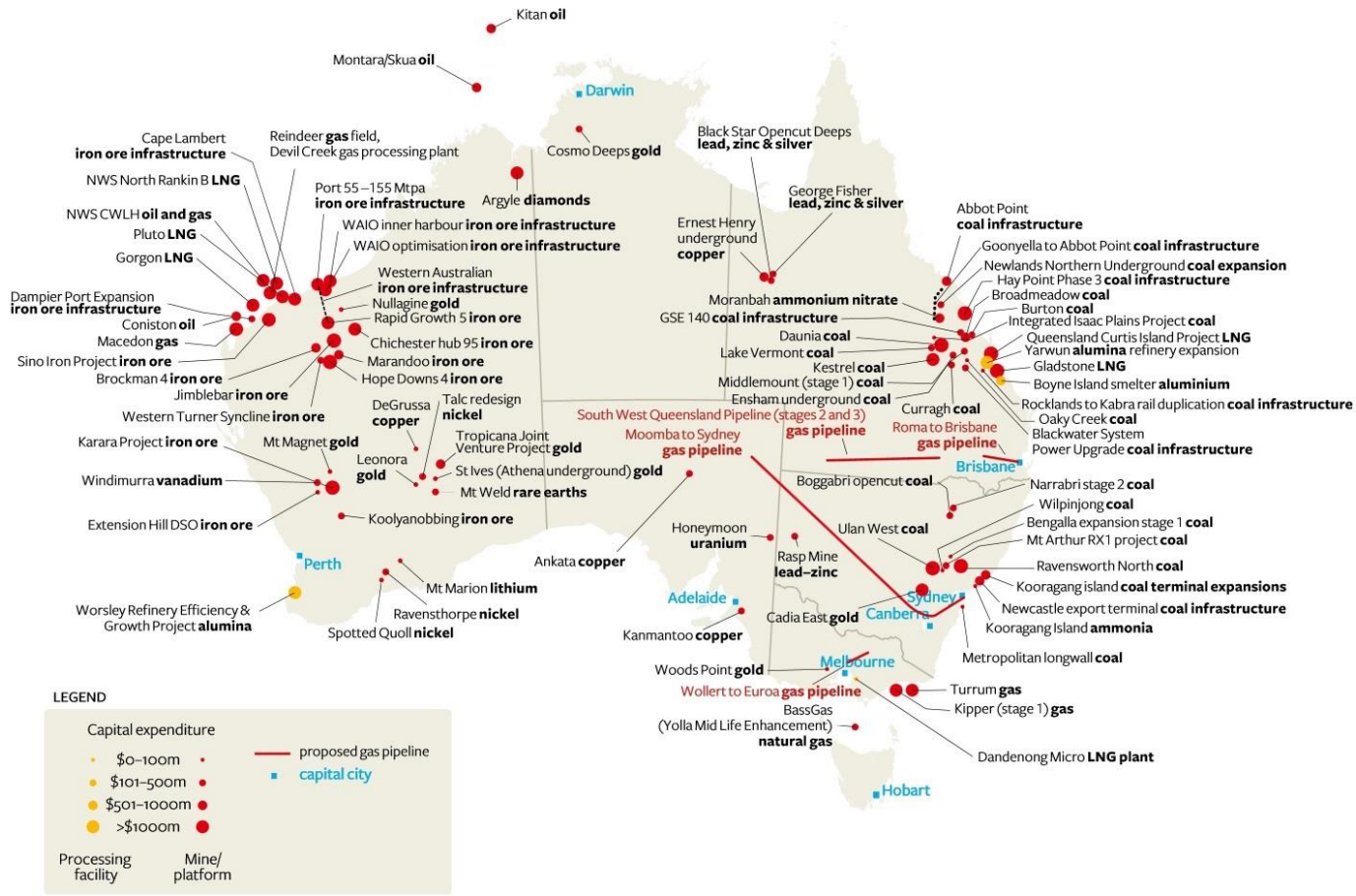
The principal consequence of China’s growing material importance to Australia has been to increase the power of the mining sector. The mining lobby in Australia has always been influential; what sets the current generation of mining companies apart is their willingness to intervene directly in the domestic political process (Beeson, Soko and Young 2011:1374)

The best example of their increasing power and willingness to use it is their hand in the fall of Kevin Rudd from the position of Prime Minister. After the Rudd government introduced a new mining tax (the Resource Super Profit Tax), the mining companies launched a massive public campaign, including TV advertising, tearing the proposed tax to pieces. The Labor Party in general and especially Kevin Rudd subsequently lost public support, and the Labor Party moved to replace him (Beeson, Soko and Young 2011:1374).

Some states also have more at stake than others in the trade relationship with China. Australia’s minerals are spread all over the country, but the mining of certain key minerals are concentrated in individual states. Just about the whole iron ore industry is located in WA, with 97 percent of the total production. More specifically iron ore is mined in large quantities in the, dry and thinly populated Pilbara region all the way to the north of WA²². Mining of Zircon and nickel is also concentrated in WA. Black coal is concentrated in the eastern states of New South Wales and Queensland, while South Australia is dominant in copper and uranium (Huang and Austin 2012:5). This is illustrated in figure 4 below, which shows the largest resources projects in Australia by value (although it is harder to see the uranium and copper mines in South Australia as the biggest dots represent the bigger operations in terms of value).

²² 97 percent of the iron ore mined in Australia comes from WA (Huang and Austin 2012:5).

Figure 5: Major resources projects in Australia (2012).



(Source: BREE 2012b:13)

However, WA is by far the most resource based economy of the six states, its resources sector accounting for a quarter of its GDP (Huang and Austin 2012:5). Huang and Austin (2012:102) ask themselves ‘Is it actually possible to overestimate how much influence mining and other resources have on the thinking of WA’s political and commercial elite?’ before giving their opinion: ‘The answer, for the researchers of this book, is a definite NO’. One can therefore expect the mining lobby to have a particularly strong standing in this state. Also, mostly because the whole iron ore industry is located here 70 percent of Australia’s exports to China came from the state of WA in 2012 (Department of State Development 2013:7). Reflecting this WA was also worst off directly after the GFC caused a slump in demand for iron ore and other minerals. One commentator wrote that the ‘sweeping lay-offs by the big miners’, threatened to turn the WA capital of Perth into a ‘ghost town’ (Malkin 2009). That should also mean that the politicians and government of WA are particularly attentive to China.

Furthermore Chinese investments in Australia have been particularly concentrated in the iron ore industry in WA. Historically, it is interesting to note that until the late 1950s WA was an agricultural state, the only mining activity at the time was in gold. It was the Japanese steel industry that originally gave birth to the iron ore industry in WA in the 1960s by sponsoring new mines as part of its 'Kaihatsu Yunso' investment program. The domestic capital market was too shallow to support the massive investments in towns, railways, roads and ports that were needed for an iron ore industry. Nor was there a market for it before Japan's own iron ore production proved insufficient (Hansard 2008; Wilson 2011a).

4.2.2 China's sensitivity and vulnerability

China, who has historically been largely self-sufficient in many mineral and energy products, has become increasingly dependent on foreign supplies of many of these products. China's demand for many of these commodities accelerating in the 2000s (Coates and Luu 2012:2), and a situation of structural economic scarcity that has characterized many of these markets under the period under study, has made Beijing concerned about sensitivity to prices in world markets in some commodities and the physical availability of other commodities.

China's sensitivity to iron ore prices – China's sensitivity is of a different nature from that of Australia. As a direct result of going from self-sufficiency to dependence China has become sensitive to prices in international mineral markets. For the commodity that has been most important in the trade relationship with Australia, iron ore, prices rises have been dramatic throughout the decade, something that has been of great concern to policymakers.

The Chinese steel industry was largely self-sufficient in both coking coal and iron ore through to the first half of the 1980s. The steel firms owned and operated iron ore mines in close proximity to their steelmaking facilities, and coal was supplied under the national plan by the state-owned coal mining industry. Domestic sources of coking coal remained sufficient for the steel industry's needs throughout its rapid growth period, but domestic sources of iron ore did not (Wilson 2011a). The steel industry increased its imports of iron ore from world markets gradually during the 1990s, before demand increased relatively quickly in the 2000s (see table above).

Since the late 1950s the regional Asia Pacific iron ore market had followed a cyclical pattern; periods of excess demand was followed by periods of excess supply, as buyers and sellers wrestled back and forth for market power. In the 1960s prices were low both because the new Australian iron ore industry was totally dependent on the Japanese steel industry as a source of

capital and a market of exports, and because the Japanese operated a highly coordinated import cartel. Following Australian nationalization policies and high prices throughout the 1970s, the Japanese steel industry invested heavily in new production particularly in Brazil in the late 1970s, and in the 1980s there was excess capacity and low prices. This meant that high-cost miners had to close down, and in the 1990s the production of iron ore was concentrated in Brazil and Australia, while Japan and South Korea were the biggest consumers. Furthermore a 'triopoly' had been established on the supplier side, with the large Australian-based BHPB and Rio Tinto along with Brazil's Vale, commonly referred to as the 'Big 3'. But their market power was 'cancelled out' by the Japanese steel industry's import cartel. The Japanese import cartel would negotiate an annual 'benchmark' price with the Big 3 on behalf of all the region's steel producers. This price was then transmitted into the Atlantic region and became the world price (Wilson 2011a)²³.

In the 1990s the Chinese steel industry got the price that the Japanese cartel negotiated, but as China gradually became the biggest consumer of iron ore, they sought to displace the Japanese in the annual iron ore price negotiations. Unlike the Japanese steel industry however, the level of ownership integration with their new main suppliers (the Big-3) was relatively weak. Also unlike the Japanese steel industry, the Chinese steel industry was highly fragmented and lacked the capacity to coordinate their actions during annual price negotiations. There was no longer an informally organized import cartel capable of negotiating collectively with the Big-3 miners (Wilson 2012a). Julian Robin Paul Tapp, head of Government Relations in Fortescue Metals Group (FMG)²⁴, put it this way in a Senate Committee hearing:

...it is not necessarily a market clearing price that will be dictated as if it is a completely free market. It reflects the negotiating strength of the two parties. Although that is clearly related to underlying supply and demand, it also reflects the profitability and various other factors that go into your negotiating position (Economics References Committee 2009b:27).

A senior researcher at the China Institute of International Studies gives an interpretation that is more representative of the Chinese view:

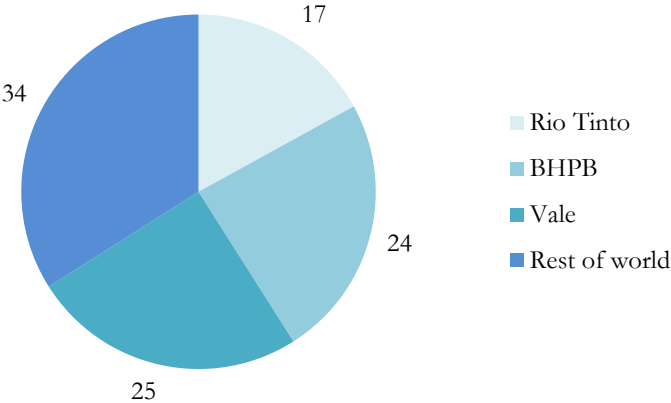
BHP, Rio Tinto and Vale have the ability to set the price. When they say they want a long-term contract, they get a long-term contract, and when they say they want to sell short term, we have to accept. The price is not made by market forces but by monopoly forces (Quoted in Uren 2012:220).

²³ This is a very short summary of the developments in the Asia-Pacific steel production networks. See Wilson (2011a) or Wilson (2013) for a more thorough assessment.

²⁴ FMG is currently the world's fourth biggest producer of iron ore.

Figure 5 below shows the percentage of the seaborne market commanded by the Big 3 in 2009. The seaborne market is the most relevant indicator, as much of the production of iron ore comes from small producers primarily supplying domestic markets – the Chinese iron ore industry is a good example. The Big 3 commanded about a 66 percent share of the seaborne trade market in 2009 (Plaizier and Nachtergaele 2009).

Figure 6: Seaborne iron ore by supplier.



(Source: Plaizier and Nachtergaele 2010)

It is difficult to say exactly how much of the price increases are the result of underlying supply and demand conditions and how much is the result of the negotiating strength of the two parties. But with soaring demand and a lack of price leadership on the consumer side, the Big-3 miners pushed for very rapid price increases. It started in April 2005 when the negotiations ended in a 71 per cent price increase (see figure below).

After the great financial crisis demand for iron ore dropped, but as a consequence of China’s stimulus package demand tightened again, with prices of iron ore peaking at US\$170 per ton in April 2011. This was a nine-fold increase on the prices a decade earlier.

Figure 7: Iron ore prices in the 2000s, US\$ per ton.



(Source: Reserve Bank of Australia 2012:15)

The price increases were not good for the Chinese steelmakers. Zhang (2011:86) notes that: ‘Consuming around 50 per cent of internationally traded iron ore, China was *extremely sensitive* to the rising price, which drove down the profit margins of its steel industry’ [emphasis added]. Increasing iron ore prices were not translated into equivalent increases in steel prices. From 2005 to 2010 the price of Chinese steel increased by 33 percent while the iron ore price in the same period grew 116 percent (Dou 2012:134). Furthermore in the Asian region the Chinese steelmakers were hit hardest because they had lower technology levels than their counterparts in Japan and Korea (Wilson 2012b:3). While the steel industry’s profit margins have been eroding, the big miners recorded record profits (Dou 2012:134). China ‘was not able to convert its standing as the world’s largest importer into a dominant position in the annual negotiations for benchmark iron ore prices’ (Leaver and Kelton 2010:265).

Both BHP and Rio Tinto, which have used their market power at the Chinese steel industry’s expense, have a large percentage of their iron ore operations in Australia. But a key point to note here is that even so the Australian iron ore sector as a whole has a geographical advantage to its major competitor, Brazil (Huang and Austin 2012:78). Shipping costs are an important part of the equation in bulk commodities like iron ore. Reflecting this, Australia has throughout the period in question provided China with iron ore that is US\$12 cheaper per ton than its main rival (Lee 2012:160).

China’s vulnerability – It has already been pointed out that China has imported close to 40 per cent of its total iron ore imports from Australia in the period under study, and that interruption of trade flows in this commodity would have huge cost to China. For several of the other

minerals and energy products China is not vulnerable to an interruption of trade with Australia specifically. In the metal mineral markets the period has been characterized by a huge increase in China's demand for these products, and a shortage because of supply (Streifel 2009). The point is that for some of these minerals Chinese leaders are probably as concerned about their *total* vulnerability, i.e. shortages of supply on world markets. That has also been shown to be the case in energy markets. For LNG and uranium for instance, supply from Australia is seen to be of considerable importance, something that is evident from the fact that these deals have been concluded at the highest level of government.

4.2.3 Economic pressure

Based on the above interpretation, in this section I will briefly assess the ability of the two to act on economic threats.

Economic pressure I – There seems to be very high costs to both sides of using economic pressure involving interruption of already existing trade flows. In iron ore, it has been established that both parties are vulnerable. Although Australia's 'resource economy' as a whole is dependent on China the raw materials besides iron ore does not make up a large enough share of Australia's total trade to make any real impact. Furthermore, in a situation with tight demand, where China has undergone a series of tipping points becoming increasingly dependent on foreign supplies of such commodities, such economic pressure would also have considerable cost to China. Australia is in no position to make economic threats of this kind, because it would soon see its status as a reliable supplier disappear

Economic pressure II – In the context of China's increased dependence on international markets and concerns over resource security, it is reasonable to expect that China will not close the door on future flows of these commodities because of political issues. In LNG or other energy products it is unlikely that contracts will be awarded on the basis of non-compliance with political demands. In iron ore, it could be that China would want to diversify its sources to become less reliant on Australia, unrelated to any threats of this kind. However, even then they will also have to take into account that Australia at least so far is significantly cheaper than the alternatives.

This might also make the threats less credible in Canberra. As mentioned in 2.2.2 and 2.3.1 an additional factor here of is Beijing's close relationship with its SOEs, which might lend credibility to threats of interruption of future trade flows. Furthermore the willingness of Beijing to apply

economic pressure in its recent history might also be something that lends credibility to its threats.

4.3 Economic Interdependence Summarized

It is clear that the Sino-Australian relationship is characterized by economic interdependence in the true sense of the word; for both there are huge gains from the bilateral trade. As they have become increasingly dependent on one another throughout the decade, their economic relationship seems fairly balanced. From the three indicators that were used I found that Australia was more dependent on China as a market for exports of resources, while China was more dependent on Australia as a source of supply. It was noted that iron ore seemed to be of special significance to both sides; Australia's exports to China of this commodity represented 16.7 percent of its total merchandise trade in 2011. It was shown that China considered iron ore to be particularly important because of the importance of its steel industry, and because 40 percent of China's imports throughout the decade came from Australia.

Australia has become increasingly sensitive to changes in the Chinese economy, particularly in the context of the GFC, as demand from other countries has slowed down considerably. Even so I argued that there is no direct connection between the Australian economy's sensitivity to changes in the Chinese economy and China's ability to use economic pressure against Australia. While Australia may be vulnerable to interruptions in its iron ore trade, China is also vulnerable in this commodity. In the context of shortage of resources Chinese leaders have also been concerned with their industries sensitivity to prices in international mineral markets and to interruptions in the flow of others. For the commodity that has been most important in the trade relationship with Australia, iron ore, prices rises have been dramatic throughout the decade and the Chinese steel industry has been sensitive to the price increases. It was pointed out that Australia supplied China with cheaper iron ore than did Brazil.

I also looked at the three mechanisms in light of the abovementioned findings and arguments. For vested interests it was shown that the mining lobby has grown in importance in Australia. WA is by far the most resource-based state, and the mining lobby can be expected to have an especially strong standing here. Furthermore WA accounted for 70 percent of the exports to China – therefore it can also be expected that the politicians in this state will be particularly attentive to China. For the two forms of economic pressure I argued that it is highly unlikely that either side could use the first kind. For the economic pressure of the second kind I argued that

resource security will probably weigh heavier to Beijing than the wish to punish the counterpart over non-compliance with political issues.

5 Conflicting interests and political leverage

Having established the dependence of the two parties on each other in the period under study, it is time to explore what consequences the economic dependence has had in areas where there have been conflicting interests. The chapter is divided into four parts. In 6.1 I will look at two *economic* conflicts, the first relating to the pricing of iron ore and the second one related to Australia's foreign investment regime. These two conflicts are treated in one subchapter because they cannot be understood separately from each other; they need to be told as one story. As the two are treated in one subchapter this subchapter will consequently be significantly longer than the two following subchapters. In 5.2 and 5.3 I will look at two areas where there has been conflict due to *political* differences. In 5.2 I look at the tensions that stem from the fact that they are not strategic allies; Australia is a close ally of the US while China has a complicated relationship with the latter. In 5.3 I look at one tension that stems from the fact that their political systems differ widely, namely the human rights issue. Each of these three subchapters starts off by discussing and defining what the interests of the two parties are in each issue area, then goes through the most important events of the period in that issue area, before looking at what role vested interests have played in that issue area and summarizing the subchapter. In 5.4 I draw out the main points of the three preceding subchapters, and discuss these findings while also substantiating the interpretations that are made by drawing on the views of the respondents on these issues.

The period that is the focus of this study can largely be divided into three parts. From 2000 to late 2007 relations were growing warmer, although there was some tension in some of the issue areas. From 2008 to late 2009 there was high tension in all four issue areas. From 2010 to present there has generally been decreasing tension, with some notable exceptions.

5.1 Economic Conflict: Trade and Investment

In this subchapter I will look at two conflicts that have characterized most of the period under study. The prices of iron ore has been a recurrent diplomatic issue throughout the period. The Chinese central government has led the response to address the resource security of the Chinese steel producers, both through attempts to convince the Australian government to establish a government-level cooperation agreement on pricing, and most notably through an ambitious foreign investment program. The bulk of the investments in iron ore were concentrated in Australia, but the sudden rush of investments was regarded by the Australian government as a

mixed blessing. They introduced new foreign investment guidelines for state owned entities in 2008, mainly intended to limit the ability of Chinese SOEs to gain too much influence over the prices of key commodities including iron ore. The Chinese government regarded this as discriminating Chinese investment. Both of these conflicts reached their highpoint in 2009, when Chinalco attempted to buy an 18 percent share in Rio Tinto but failed, and an Australian citizen who was also Rio Tinto's chief negotiator in the annual price negotiations was arrested in China and accused of bribing the steel companies to gain an upper hand in the negotiations.

5.1.1 The interests of the two parties

As already shown the Chinese steel industry was very sensitive to increasing prices. It has also been shown that the Chinese government regards its steel industry as strategically important, nicknaming it the 'food of other industries'. The interest of the Chinese government is therefore in helping its industry secure low and stable prices of iron ore. Long Guoqiang, head of international research at the State Council's Development Research Centre, identifies the challenge in the following way:

The security issue is not that China cannot get from abroad the resources it needs (...) the security issue is the problem of price (...). Although China is the biggest importer for many major resources, in fact we have very limited influence on the price (Quoted in Uren 2012:220).

When Chinese scholar Ding Dou²⁵ assesses the problems for China in its economic relationship with Australia, he points to the fact that Australia's terms of trade has reached historical highs and mining firms operating in Australia have recorded record profits, while at the same time the Chinese steel industry's profit margins have been eroding (Dou 2012:134-135). Consequently, Beijing has sought to address the problems of its steel industry by a range of initiatives.

For Australian government at the state (of WA) and federal level high prices mean healthy rents. Furthermore state intervention in markets does not sit well with what is characteristic of Australia's approach to trade. Any suggestion of markets not being the sole determinant in pricing is laughable. The same applies to the government's approach to FDI from China. In the words of one respondent: 'Anybody can invest here, with certain conditions, provided they're profitable and market dominance type conditions are met, and the odd security ones. Then we couldn't care less. As an open economy we welcome everybody's money'²⁶. Although Australia's

²⁵ Ding Dou is Professor at the School of International studies at Peking University.

²⁶ Interview with Neil Roberts, adviser to the Minister of Resources, Energy and Tourism.

government wants investment from China, it seems to also to want to limit the degree of control that Chinese SOEs are able to exert on prices of key commodities. The main concern seems to be that these SOEs would be able to manipulate prices of iron ore.

The afore-mentioned Mr. Tapp of iron ore miner FMG gave this account of what FMG's own concern was with Chinese SOEs investing in the company.

There is an issue when the intended target of a company is significant in size and they want more than 50 per cent of it. I will be quite clear about what our fear is: investment in expanding production for the sole purpose of increasing supply to drive the price down. (...) Clearly, when large companies like Fortescue, Rio or BHP are involved, they are able to increase their production to the point where they can have a material impact on the overall supply situation (...) Even though that would be bad for the company, it would ultimately be good for the customer. If you are the Chinese government and you own both the company and most of the steel mills, it can be in your interest to engage in such commercial activity (Senate Hansard 2 July 2009:29).

This concern was shared by the Australian federal government and Treasury. They did not rule out the possibility that the Chinese SOEs would seek to for instance expand production even when this was commercially unjustified. Furthermore, in instances where the major Australian companies were involved there could be a conflict of interest if the Chinese were allowed Board representation. If the Chinese investors had information about the cost structure, pricing and marketing strategies of large Australian iron ore miners, that information could in theory provide the steel industry an advantage during benchmark negotiations. Whether or not the Chinese companies would in fact use increased control to the advantage of their home government and steel industry's is beside the point for the purpose of this study. The central point is rather that the Australian government does not know whether or not they would, and therefore seems to have made decisions based on the assumption that they might.

5.1.2 China's resource diplomacy and government-led investment program

Between 2000 and 2004 the Chinese government moved towards a less interventionist approach to its state owned enterprises. But as domestic demand for raw materials soared after China's entrance into the WTO in 2001, the issue of resource security was starting to worry the Chinese leadership, and they saw a need for increased state control in the natural resources sector. China had launched the 'Going Out' program at the start of the millennium. As China gradually opened up its own markets to foreign multinationals, the Going Out program was originally meant to spur large but domestically oriented Chinese companies to take competition to these foreign

companies' home markets. Putting its huge amounts of foreign reserves to work, Chinese companies were encouraged to invest in and acquire foreign companies (OECD 2008:83-85).

However the Going Out program took on a new dimension as the problem of resource security took on greater significance. In March 2004 Premier Wen Jiabao announced that the state would take a greater role in coordinating and guiding their companies' outward foreign direct investment. In October that year the 'Outbound FDI Catalogue' was released, listing seven industry sectors where the state would provide interest-subsidized loans to support FDI projects, including in natural resources (OECD 2008:83-85). The same month another OFDI promotion policy was issued by the National Development and Reform Commission (NDRC) and the state-owned Export-Import Bank of China (China EXIM Bank), where these two would facilitate special loans for overseas investments 'to support key overseas investment projects encouraged by the State' (NDRC and China EXIM Bank 2004). Among the four types of projects listed natural resources development was number one. Chinese SOEs had to apply to the NDRC, which made state budgetary resources available to the China EXIM Bank, which made discounted loans back to the SOEs. The Chinese central government also started a diplomatic push to help its SOEs win contracts and resource exploration rights, including through high level diplomatic visits accompanied by business delegations (OECD 2008:83; Kong 2010). Resource security has also been a factor in China's push for bilateral FTAs, where so-called resource clauses have been included or sought included in many of the negotiations (Wilson 2012b).

In relation to the most important mineral that Australia supplied, it has already been established that China's steel industry was sensitive to the rapid price increases that started in earnest in 2005. The sensitivity of its steel industry immediately got the attention of the central government. Only three months after the April 2005 price increases the NDRC issued a national *Iron and Steel Industry Development Policy* (Wilson 2011a:260). The policy document contained three goals to improve the competitiveness of the Chinese steel industry in the face of rising costs of needed raw materials. First, at the industry level the goal was to accelerate consolidation through government-brokered mergers and government-financed technical upgrading projects, as the industry was highly fragmented, and inefficient due to low technology levels (Wilson 2011a:256). The second goal was to create a Chinese importers' cartel by promoting coordination between Chinese steel firms, and thus counterbalance the power of Rio Tinto, BHPB and Vale in the annual iron ore price negotiations. The third goal was to encourage steel firms to invest in iron ore projects overseas through an ambitious investment program. This was to be done through a

range of financial incentives provided by the state through China EXIM Bank, China Development Bank and several other state owned banks (Wilson 2011a:256).

A closer look at the third goal is needed to understand the subsequent conflict. The *Iron and Steel Industry Development Policy* listed six minerals where investments by the steel industry would be subsidized (Wilson 2011:260). It seems that the goal of this mineral investment program was to improve China's steel industry's disadvantageous position in the market relative to competitors in other countries and the Big-3 suppliers. It was an explicit attempt to emulate the Japanese steel industry's 'Kaihatsu Yunso' strategy of the 1960²⁷. Wilson (2011a) identifies three goals in the investment program. First, it was intended to increase total global supply of needed raw materials and thus improve the steel industry's supply security. The second goal was to develop 'captive mines' controlled by the Chinese steel firms, and thus establish the same kind of ties that the Japanese steel industry had during the 1960s. The third goal was to raise the proportion of minerals imported on long term contracts, so as to stabilize the prices (Wilson 2011a:262-263). In the second and third goal there was a potential for conflict between the two parties.

The results of the government led investment program were dramatic. The Chinese steel industry lacked the capital to carry out these kinds of investments on their own. But between 2002 and 2010 Chinese firms made 45 investments in foreign iron ore and coking coal projects worth US\$40 billion. 41 of these investments were made after state financial support was made available and 34 of them were in Australia, accounting for 69 percent by value (Wilson 2012a:259-261). Why was so much of the investment concentrated in a country that already supplied China with 40 per cent of its imports? The president of Minmetals Zhou Zhongshu explains why Australia was favored initially:

There are three main countries for iron ore deposits, Australia, Brazil and South Africa. The country I would definitely like to have investment in is Australia. It has geographical advantages and favorable investment conditions (Quoted in Huang and Austin 2012:38).

The fact that the Chinese steel industry invested so heavily in a country that already supplied it with about 40 per cent of its iron ore resources serves to further underscore that Australia is considered a fairly reliable provider.

The investment program was not the only initiative by the Chinese government. The FTA negotiations that commenced between Australia and China in 2005 were partly motivated by a

²⁷ In 2009 CISA described investment program as a direct attempt to emulate Japan's strategy (Steel Guru).

concern over resource security (Wilson2012b; Jiang 2008). It is also clear that different levels of the Chinese government initially tried to convince the Australian government to intervene in price negotiations, and that the Australian government declined that it could play such a role.

5.1.3 China demands intervention in the market, Australia sticks to free market approach

Starting in 2005 Chinese officials from the Ministry of Foreign Affairs lobbied both the Australian government and Australian industry groups to intervene in pricing of iron ore. According to the New York times they were warned that: ‘the price increases could hurt the Chinese economy and undermine long-term trade ties just as suppliers of raw materials in Australia enjoy a boom arising from China's soaring appetite for commodities’ (Lague and Arnold 2005). Before a visit by Prime Minister John Howard’s to Beijing in 2005, Chinese Foreign Ministry's director-general for North America and Oceania He Yafei told the Australian media that they were concerned about the recent price increases and that Canberra could ‘certainly encourage companies to take a long-term point of view in setting prices [and] don't just look at the benefits under their noses’ (Hartcher and McDonald 2005). On a visit to Australia in April 2006 Hu Jintao sought to have the contract negotiations out of the hands of the private sector entirely. He said it was the responsibility of the two governments to ‘put in place a fair, open and reasonable market order as well as to come up with a pricing mechanism that is in accordance with international practices’ (Uren 2011:156). At this stage Beijing also had high hopes that the FTA that had commenced the same year could include a resource clause to ‘lock in’ supply from Australia at relatively stable prices (Jiang 2008:180).

That an FTA would improve China’s resource security was one of several arguments that was used by Australian diplomats when they convinced the Chinese to commence negotiations²⁸. But what the Chinese were proposing was out of the question for Canberra. It would be contrary to the Australian free market approach to trade and break with established corporate norms (Raby 2013; Huang and Austin 2012:78). It seems Canberra equally tried to convince Beijing to accept that prices would be determined by the market. In 2006 for instance, when it was Australia’s turn to chair the G20, Australia chose to focus on the issue of resource security, bringing to the table a clear message: trust the markets (Parkinson 2006).

But it does not seem like this message did much to reassure the Chinese. Top diplomat and Ambassador to Australia from 2004-2007 Fu Ying made it clear throughout her period that

²⁸ Interview with Geoff Raby, deputy secretary of DFAT at the time.

BHPB and Rio Tinto should show more restraint (Lague and Arnold 2005)²⁹. Several of the respondents mentioned that Ying had expressed concern to them about the rising prices. The Senator of the Liberals said that:

I used to be very friendly with Fu Ying (...) The Australian iron ore companies kept on putting up the prices on a quarterly basis, and that quite irritated the Chinese. She used to talk to me about it, saying: 'if you keep putting up the prices, we will go elsewhere'. And nobody really took that very seriously. I went to an annual conference in Scarborough a few years ago where she gave the keynote address. She said that 'what we want is a stable win-win relationship. We will pay reasonable prices, but if you keep on trying to exploit the relationship through high prices we will go elsewhere'. I walked out with her and told her 'those were strong words'. She answered: 'well, they needed to be said' (Interview with Alan Eggleston, Senator of the Liberals)

According to other respondents some Chinese officials misunderstood Australian authorities' ability to dictate companies operating in Australia³⁰, perhaps because it stood in stark contrast to the Chinese government's ability to do so. However, it was made clear that Ying had no delusions about this³¹. The message seems fairly clear. Either the Australian government convinces its mining companies in some way to be more reasonable in setting prices, or China would take its business elsewhere. In a sense this was more of a statement of the facts than a threat that China would act upon when considering the history of this particular market. As shown, cyclical periods of oversupply have been followed by structural economic scarcity, and control has been wrested back and forth between buyer and seller. Recall also that at the time the only large scale alternative supplier was Brazil, who was already running at full capacity in the context of a sudden rush in demand. Furthermore Australia already provided China with cheaper iron ore than Brazil because of lower shipping costs.

Even though Canberra declined to get involved, the government privately made BHPB and Rio Tinto aware of the Chinese position (Lague and Arnold 2005). There is no doubt that such meetings also took place at the state level, between the Premier of WA and the major companies³². This is to be expected; Australia's iron ore industry is located in WA, and it would also be WA that risked losing important future market shares and investment, and thus revenue and jobs. With that said, the federal and state government's concern of long term implications for the relationship with China probably meant little to the managers of these companies compared to the short term pressure from the shareholders for healthy profits.

²⁹ Madame Fu Ying is currently Vice Foreign Minister.

³⁰ Interview with Jeffrey Wilson, interview with John Ravenhill.

³¹ Interview with Neil Roberts, adviser to Minister of Foreign Affairs.

³² Interview with Norman Moore, Minister for Mines and Petroleum in WA.

Pricing arrangements of this kind has been suggested on the Australian side as well. In 2010 Australian Strategic Policy Institute (ASPI) for instance suggested that ‘we leave behind the package of illusions about ‘normal commercial relations’ in iron ore’ (Leaver and Ungerer 2010:22). They propose an annual ‘strategic economic dialogue’ in iron ore at the ministerial level with the participation of the major companies and relevant subnational authorities from both sides, coupled with an international commodity agreement (Ibid:22-23).

Another approach was suggested by former chairwoman of Baosteel Xie Qihua. She made it clear in 2007 that Chinese enterprises had the money required to secure Australian resource investments, but that the time to make a deal could be running out:

‘This is a critical time for both countries. China has rapid demand and they need more iron ore. Later, it is hard to say because the situation may change. If they [Australian miners] can decrease [the price] a little but not too much, then both countries can feel good about each other and make a good deal (...) Our budget is open. As soon as we make a deal with our business partners we can make our investment straightaway’ (Quoted in Huang and Austin 2012:78)

The next section clearly shows that any investment deal involving the manipulation of prices was off the table for Australian authorities.

The Chinese preferred long term deals with the companies like those outlined above, or an arrangement where the Australian government would somehow intervene in the setting of prices. However, Canberra would not budge on this question. But was the alternative choice for the Australian government ‘sitting idly by while Chinese authorities slowly impose their own conception of order on the demand side of the market’ (Leaver and Ungerer 2010:22)?

From 2005 to 2009 the iron ore price negotiations grew tenser (Wilson 2011a:285-291). Would this conflict ‘spill over’ into the broader trade relationship?

5.1.4 Chinese investment and the Australian government’s response

In this section I will show how the wave of Chinese direct investments outlined in 6.1.2 was received in Australia. Most notably the Australian Treasury introduced new guidelines for FDI from state owned enterprises, signaling a tighter screening regime in FDI. The investments in coal has not become a political issue as of yet, so the focus here will be on iron ore. The Australian government feared that allowing too much control would give the Chinese SOEs the ability to manipulate prices on behalf of their domestic steel industry. The Chinese held the

opposite view: they thought the major miners were ripping them off. There were other concerns with Chinese SOE's investment as well, that were not directly related to control, such as defense concerns and competition policy concerns.

'What I do know is that this deal is not good for me' – Former Premier Wen Jiabao

If the Chinese were to seriously be able to influence prices in the short term they thought it necessary to break up the oligopoly power of the Big 3. In 2007 it seemed that the opposite was about to happen. BHPB had long thought about the idea of merging with Rio Tinto. The official rationale was that Rio Tinto had better infrastructure while BHPB had better iron ore bodies; and together they could achieve greater economies of scale (Uren 2012:67). But it would also result in market dominance across a range of commodities including iron ore (Leaver and Ungerer 2010:16). Partly motivated by the fears of being taken over by BHPB, Rio Tinto acquired the Canadian aluminum company Alcan at a top market price of 38.1 billion in 2007. This significantly increased Rio Tinto's debt, and was therefore considered by industry analysts at the time as a barrier to further M&A. This did not stop BHPB, however. In November 2007 they made a merger offer to Rio Tinto, which was based on three BHPB shares for one Rio Tinto share, thereby valuing Rio Tinto at 150 billion. The board of Rio Tinto immediately rejected the deal (Huang and Austin 2012:141), but it was unclear at the time what the outcome would be.

The prospect of a merger between these two mining giants was not well received by Chinese authorities and steel industry. There was particular concern over what this merger would mean for prices in iron ore, as the two companies at the time had control over about 40 per cent of China's total import needs (Uren 2012:67). This is reflected in Chinese reactions to the announcement of the deal:

It's terrible. If completed, the deal between Rio and BHP would create a mining giant enjoying a monopoly in many minerals resources and a further lessening of competition, and would thus lead to hikes in iron ore prices - *China Mining Association's deputy secretary general, Liu Yikang* (Quoted in Tan 2008)

I don't know a lot of things but what I do know is that this deal is not good for me - *Former Premier Wen Jiabao* (Quoted in Murphy 2008)

In November 2007 the NDRC held a series of meetings with amongst others Chinalco, the coal group Shenhua, Baosteel and China Development Bank to discuss 'counter-measures' to the proposed deal. In the end Chinalco was selected by the NDRC, but other companies were also

considered (Drysdale 2011:60; Uren 2012: 69). The 1st of February 2008 Chinalco in partnership with Alcoa bought a 9 per cent stake in Rio Tinto for 14.05 billion. The market price Chinalco paid was very high, and Chinalco had to take on debt equivalent to 80 per cent of Chinalco's annual sales to do it. The acquisition was therefore widely regarded as strategically motivated, not financially; aimed at blocking BHPB's potential acquisition of Rio Tinto (Huang and Austin 2012:142).

The Australian government's policy towards state-owned entities (SOEs and SWFs) was well known at the time. According to the 1973 Foreign Investment Act (see Appendix) all investments by state owned entities had to be assessed by the Australian Foreign Investment Review Board (FIRB) to determine whether the investment was in the 'National Interest'³³. The FIRB then gave a recommendation to the Treasurer, who could ask the FIRB to review the proposal a second time. What was perhaps less clear to investors was what the National Interest meant. But by making the transaction through Rio's London share register, Chinalco circumvented the Australian policy of requiring approval for foreign investment by SOEs. This was not well received in Canberra. The president of Chinalco Xiao Yaqing nonetheless decided to run the transaction by the FIRB even though he did not consider Chinalco legally obliged to do so (Leaver and Ungerer 2010:17). BHPB's initial response was to up its bid to 3.4 BHPB shares for one Rio Tinto share on the 6th of February 2008, but over the course of the year this seemed less attractive because of the global financial crisis and price slumps in the commodities market. That bid was withdrawn on the 25th of November 2008 (Huang and Austin 2012: 141-142).

This particular investment sparked intense political debate and public interest in Australia; something that will be discussed in further length in section 5.1.7. It seems that this debate was what Prime Minister Kevin Rudd had wanted to avoid. Early on in his term Rudd had requested revised guidelines for foreign investment from SOEs, outlining how to deal with high-profile Chinese takeovers of major Australian companies (Raby 2013; Uren 2012:67).

Treasury introduces new guidelines for state owned entities

The bid coincided with a huge increase in investment by Chinese SOEs in Australia's resource sector (Drysdale 2011). The response came only 18 days after Chinalco's bid, when the Treasurer issued a new set of guidelines outlining the issues that the FIRB assessed when considering

³³ For private companies FDI below the (indexed) threshold of 248 million is not subject to FIRB approval. The threshold is substantially higher for US investors (FIRB webpage).

whether investments by state-owned enterprises were consistent with the 'National Interest'. The guidelines consisted of six 'principles' against which the FIRB assess investment proposals when making its recommendation to the Treasurer. Among these were the following two (Swan 2008a):

- An investor's operations are independent from the relevant foreign government
- An investment may impact on Australia's national security

The first principle, by far the most important one, meant an assessment of whether the investment was 'a true commercial focused investment', or whether there were other motives driving the investment (Colmer 2009). Treasurer Wayne Swan made this point clear in a speech, saying that foreign investment in Australia:

...should be consistent with Australia's aim of maintaining a market based system in which investment and sales decisions are driven by market forces rather than external strategic or political considerations (...) Australian governments (...) 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 (...) it 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 2008b).

The Australian government stressed that the issuance of these guidelines was needed to clarify to investors what the rules were, and also that the rules would be universally applied. The timing of the release nonetheless suggests that it was instigated by the new wave of investment from Chinese SOEs, and Chinalco's bid in particular. It also seems like it was meant to signal to Chinese investors and government that there were clear limits to what the Australian government would accept. Following the issuance of the new guidelines ten Chinese SOEs were told to resubmit their applications to the FIRB at a later date (Hewett 2008). Furthermore, a cable leaked from the US Embassy in Canberra and classified 'sensitive'. Patrick Colmer, who at the time served as the head of the Treasury Foreign Investment Division and was an executive member of the Foreign Investment Review Board, briefed US Officials at the embassy in Canberra on the guidelines. According to the cable he said they were 'aimed squarely at reducing Chinese influence in the Australian resources sector'. Based on Colmer's briefing US diplomats reported that the Australian government privately wished to 'pose new disincentives for larger-scale Chinese investments' (Dorling 2011).

Because of the emphasis on SOEs ties to their home government, the guidelines were interpreted in Beijing as specifically targeting Chinese FDI, and they moved quickly to see if a compromise could be reached. After the announcement of guidelines Chinese negotiators made the issue a top priority during the subsequent Sino-Australian FTA negotiating rounds conducted in June and September 2008 (Wilson 2011a:274).

What did the guidelines imply in practice? In a speech at the Australia-China Investment Forum 24 September 2009 Colmer gave a further clue:

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 per cent for greenfield projects and around 15 per cent for major producers (Colmer 2009).

This position was further explained in an interview with the adviser to the Minister of Resources, Energy and Tourism. He said that the Australian government's approach had been:

...very welcoming to Chinese investment. However we have let them know that we actually thought the Japanese approach of using existing or well recognized miners as joint venture partners, taking a significant but not controlling interest, we thought it was actually a better model. The [Australian] mining companies knew what they were doing, they were well experienced. The Chinese didn't take that view entirely (Interview with Neil Roberts).

When Colmer says 'we prefer' and Roberts says 'we let them know that we thought', it is important to understand that the Treasurer has the ability to demand that their control is limited, by setting an upper limit on the shares held in that company or by adding additional demands such as an upper limit on how many board members the investors can have in the target company. In the last instance the Treasurer can 'knock the deal on the head, stop it dead'³⁴. However, it is equally important to understand that these are not strict rules, but rather something that is considered from case to case. In the afore-mentioned speech Colmer pointed out that 'we do look at all investment proposals on a case-by-case basis and there are examples where we have accepted quite readily different arrangements to that' (Colmer 2009). The approach of restricting shareholding to the 15-50 limit and restrictions on the number of board

³⁴ Interview with Neil Roberts, adviser to the Minister for Resources, Energy and Tourism.

members has been applied in cases where there has been concern that foreign companies could have too much control, but this has far from been the case with all Chinese investments³⁵.

Restrictions on FDI proposals

The Australian Treasury only in very few instances discloses information on extra requirements; therefore it is hard to say exactly how many Chinese direct investments have been subject to additional demands. First it should be noted that no Chinese direct investment in Australia has been outright rejected, and that 170 Chinese investment applications were approved between the time that the Labor party took office and the end of June 2010. The Treasury has demanded that the initial propositions be modified in some high profile cases, and for many of them there have been issued press releases. Three cases that have received much media attention but nonetheless seem like outliers are the case of a Chinese SOEs attempted acquisition of an REE miner, and two concerning the acquisition of mines that were located close to a military facility. The two latter will be treated in 6.2, as they are related to security concerns.

In 2009 China Non-Ferrous Metals Corporation's (CNMC) attempted to acquire a controlling stake in REE producer Lynas in 2009. Treasury set an upper limit of a 49.9 percent share and a reduction in the number of CNMC nominated directors to fewer than half of the board of Lynas (Treasury 2011). CNMC subsequently withdrew its bid. While the issuing of such additional demands might be similar to other cases, this particular investment seems to be a special case; reflecting that about 98 percent of the production of this particular mineral was located in China (Huang and Austin 2012:67), and probably also reports at the time that China could use this as an economic weapon in the future (Bradsher 2009). The adviser to the Resource Minister explained what the concern was with this particular investment:

We've got REEs, and the Chinese will not be able to control those in Australia. There is no way that can be done. But that is because it is a dominant player in the market; the world has an interest in the market becoming more competitive. Therefore you exclude the dominant player from being in a position to extend their market dominance. The fact that it's China I would regard as a coincident (Interview with Neil Roberts).

In some cases conditions have not been imposed but the bids have nonetheless been withdrawn or resubmitted. Under the 1973 law the FIRB has to make its recommendation to the Treasurer within 30 days. If the FIRB cannot make it within this timeframe they can apply for another 90 days, but in such instances they must make the application public. When they do not make a

³⁵ Meeting with FIRB and Treasury Foreign Investment Division staff.

recommendation within 30 days this is therefore read by many as a signal that there is some sort of problem with the investment. In 2008 and 2009 47 Chinese bids were submitted to the FIRB, withdrawn and resubmitted, perhaps because they understood that the initial bids would not go through. Of these 35 were approved by the FIRB in the end, while 12 of them were abandoned by the investors (Uren 2012:81-82)³⁶.

However, the most interesting cases are the few but large investments by Chinese SOEs that have been subject to additional demands. Chinalco's bid was eventually approved after a long review process (in August the same year). However, the Treasury approved the bid on the condition that (1) Chinalco would not seek board representation as long as its share was below 15 per cent, and (2) Chinalco would not seek to increase its share without first seeking government approval (Fry 2008). The same year Sino Steel requested to buy 100 percent of iron ore miner Murchison Metals for 1.36 billion AU\$, but Treasury only allowed them a non-controlling share of 49.9 per cent to 'maintain diversity of ownership within the Mid-West region' (Swan 2008c). In 2009 Chinese SOE Yanzhou Coal requested to buy 100 percent of Felix Resources for 3.5 billion AU\$ - this was approved by Treasury but with several conditions (Huang and Austin 2012:68-69). In 2009 Chinese SOE Hunan Valin Iron & Steel Group (Hunan Valin) sought to inject 1.2 billion dollars into FMG for a 16.48 percent share in FMG, and in this deal Treasury also added several conditions that are discussed below.

The point here is that these mega-deals cover about 77 percent of the FDI from China into Australia in terms of value for 2008 and 2009 (Wilson 2011a:275). So even though there were additional demands in few cases those were also some of the most important cases. In the words of Wilson they were thus intended to 'neutralise the risks associated with Chinese state ownership and strategic behavior' (Wilson 2011a:275), striking a balance between the benefits of FDI and the fear that Chinese companies would get a large say over prices.

GFC: 'The Chinese are here with the cash and they weren't born yesterday'

In the beginning the Chinese invested mostly in newly established 'junior miners' that were at the exploration stage and needed financial support to support their exploration activities. However, in the context of the global financial crisis, in late 2008 and early 2009 there was a shortage of financing opportunities elsewhere and a slump in the demand for minerals. This opened up new

³⁶ It is also important to emphasize here that the unit responsible for reviewing investment proposals is fairly small, and may have been overwhelmed by the number of proposals that they were set to review following the rush of Chinese investment.

opportunities for Chinese firms with preferential access to capital to buy assets of more established mining firms, who were now desperate for cash (Huang and Austin 2012:36, 39). A cable leaked from the US Consulate General in Perth attests to the tricky situation for the Australian federal and state government. In the cable Head of FMG's China Marketing Division Sandra Liu warns that the government of Western Australia has to be careful not to 'sign away its future resource'. This, however, is a delicate balancing act seeing as 'the Chinese are here with the cash and they weren't born yesterday' (Wikileaks 2009a).

FMG has been quoted extensively above, and the reason for that is that they had first-hand experienced with the conflict of interest that was the Australian government's greatest concern. Starting as a junior miner in 2003 FMG has become the world's fourth largest producer of iron ore, something that would not be possible were it not for Chinese capital investment. In late 2008 early 2009 FMG was in the same position as many other resource companies: they needed cash. In early 2009 Hunan Valin agreed to invest AUS \$1.2 billion for a 16.48 percent stake in FMG. However, reflecting the concerns noted above FMG sought to limit any conflict of interest between themselves and Hunan Valin. That meant the same kind of controls that the FIRB and Treasury were seeking to apply: Hunan Valin initially wanted a bigger share. Furthermore they were only allowed one Board member, and that Board member would not have access to anything that had to do with FMG's cost or pricing structure. The FIRB, who FMG had communicated extensively with throughout the process, then put these same restrictions as conditions for the approval of the deal – giving them additional weight (Official Senate Hansard 2009:31).

At about the same time as the Hunan Valin's investment in FMG, something way bigger was about to happen. The global financial crisis hit Rio Tinto particularly hard, and the company now had massive debt. This was to a large extent due to the afore-mentioned acquisition of Alcan, a debt that was 'barely serviceable over the short-term during good times and intolerable after the commodities boom turned to bust in mid-2008' (Leaver and Kelton 2010:264). After looking at several options, the 12th of February 2009 Rio Tinto's management and board recommended a transaction with Chinalco (Huang and Austin 2012). The so-called 'Chinalco-Rio Mark II' deal would deliver US 19.5 billion dollars in cash to Rio Tinto and raise Chinalco's stake in Rio Tinto to 18 per cent. US 12.3 billion dollars would be paid to acquire part of Rio's assets through joint ventures and exploring, and US 7.2 billion would be paid in exchange for the issuance of convertible bonds by Rio Tinto. Furthermore Chinalco would be able to appoint two Board members to Rio Tinto's Board (Rio Tinto Zinc 2009a). As will be discussed in some length

below, after this deal was proposed there was intense lobbying on the part of Rio Tinto, Chinalco, and BHPB, and intense public and political opposition to the deal.

The central concern of the Australian government regarding this deal was that it could potentially give Chinalco a great deal of influence over prices in key commodities. Especially iron ore, but also bauxite and copper, all three of which China was importing in huge quantities. The 18 percent would be concentrated in a narrow range of nine mining projects which Chinalco had a particular interest in; the Hamersley iron ore operation, plus four copper and four aluminum operations (Rio Tinto Zinc 2009). The specific control which Chinalco was claiming varied across these nine projects, in the case of the Hamersley iron ore operation it was 15 per cent. In terms of value the Hamersley operation accounted for close to half of the total assets (US\$ 7188 million for the other mines combined, US\$ 5150 million in Hamersley) (Rio Tinto 2009a). It was perhaps not the ownership stakes that was regarded as the biggest problem, but rather the series of managerial controls that were proposed for Chinalco in the marketing of iron ore, copper and bauxite. Again, this must have been a special concern in iron ore. Chinalco would hold 50 per cent of the shares and appoint three of the six directors in a new marketing company, which would market 30 per cent of Hamersley's iron ore output³⁷. Chinalco would also hold 49 per cent and appoint two of five directors in an 'iron ore strategic alliance vehicle', which would provide advisory and consulting services to the board of the iron ore group³⁸. According to some analysts, Chinalco's bid was:

'...cleverly designed to give it considerable strength in the marketing and negotiation of sales contracts of the iron ore produced at Rio Tinto's Pilbara mines, vital to keeping prices low for China's steel makers. This, indeed, may have been its ultimate objective' (Yao, Sutherland and Chen 2010:323)

Chinalco was also very indebted at this time, and was only able to get funding for the deal from three state owned Chinese banks, backed by the Chinese government. Chinalco had incurred huge losses from the first acquisition of a 9 per cent share in Rio Tinto, which saw their paper value reduce by 70 percent because of the GFC (Huang and Austin 2012:83). And it certainly did not help reassuring the Australian government that Xiao Yaqing had just recently left his position as president of Chinalco to assume the post of vice secretary-general of China's State Council (Callick 2009). One of the respondents said that:

³⁷ This was equivalent to 30 million tons of iron ore in 2009 (Gottliebsen 2009).

³⁸ The 600-page deal is quite complex, and it is beyond the scope of this thesis to go into the details. See Gottliebsen (2009) for a more extensive treatment.

'It looked like a wish list for a state owned enterprise strategically trying to take control of the iron ore industry. If that was what the Chinese government was trying to do, that's exactly what you'd ask for. The point of the deal seemed to be not to gain an ownership stake in the mines per se, but to gain marketing control over a significant chunk of Rio's output of iron ore, bauxite and copper, which China was importing in vast quantities. (...) It was also running a loss at the time of the investment. In essence, it seemed to be put up to it by the Chinese government, which arranged for three state-owned policy banks to bankroll the entire deal with heavily discounted loans (Interview with Jeffrey Wilson, has done extensive research on the Asia Pacific steel production networks)

With two board members and extensive managerial and marketing control, the deal was exactly what the Australian government feared: (1) a Chinese SOE would have insight into a major iron ore producer's costs, pricing and marketing strategies, information that in theory could be used in the iron ore price negotiations, and (2) there was a theoretical possibility that this company could use its new marketing control to push for commercially unwise decisions with regards to Rio Tinto's output. There was a significant element of uncertainty at the time about whether state owned Chinalco would in fact seek to use these controls in a manner consistent with the interests of its home government and those of the Chinese steel industry. This seems to have been the major concern of the government, and of course the FIRB who had to review the proposal and make a recommendation to Treasury. Unable to decide within the normal timeframe, the Foreign Investment Review Board (FIRB) postponed its decision on the deal for an extra 90 days (Zhang 2011:80). Over these 90 days several things happened.

The board of Rio Tinto had made the initial deal in a desperate situation. As the deadline set by the FIRB was approaching, world markets were beginning to recover and China's own financial stimulus package saw a sudden increase in demand for iron ore. This no doubt made the deal look less favorable to the shareholders of Rio Tinto. With only one week left before the FIRB had to make its decision, on June 5 Rio Tinto announced that it withdrew from the deal, and that it had decided on an alternative plan (Rio Tinto 2009b). This plan involved a rights issue to existing shareholders, while simultaneously proposing to merge its Pilbara production and transport operations with BHPB, a joint venture for which Rio would receive an extra \$6 billion (Leaver and Kelton 2010:265).

Nobody knows what would have happened if the shareholders of Rio Tinto had approved the deal. Given the position that the Treasury and FIRB representatives had expressed, and their willingness to apply additional demands on such investments in other cases of high significance, most notably in the case of Hunan Valin-FMG, it is highly unlikely that the Treasurer could have

approved the initial deal. Perhaps reflecting this, Chinalco made some rearrangements of the terms of the deal well into the 90 day extension (Leaver and Ungerer 2010:20), accepting that its share be reduced to about 15 per cent (Drysdale 2011:68). In any case the fact that it was turned down by the (shareholders and) board of Rio Tinto was certainly politically convenient for the Australian government. The fact that world markets were on the rebound is only part of the explanation of why the deal failed, as will be discussed further 5.1.7.

As shown here, Canberra regarded Chinese FDI as a mixed blessing. The Australian government wants the benefits that flow from Chinese investment, but is concerned that the Chinese SOEs might gain too much direct control over its resource sector, particularly iron ore. They have therefore sought to limit the room for Chinese strategic behavior by imposing extra conditions in some of the most important deals, including it seems in Chinalco's failed acquisition of a larger share in Rio Tinto.

Chinese government threatens with trade sanctions

After the failed deal the Chinese government was furious. Chinalco's investment had been aborted for what was perceived to be political reasons, and BHPB and Rio Tinto had announced that they would join their iron ore operations, in Chinese eyes further contributing to these companies' market dominance. A cable from the US CG in Perth made public through Wikileaks attests to glum mood in Beijing. WA Premier Colin Barnett, who visited China right after the events, told Consul General Kenneth Chern that 'terms like 'treachery' and 'back-stabbing' were floating around' (Wikileaks 2009b).

In *the Sydney Morning Herald* a Chinese Official was quoted saying that the Chinese Government could impose trade sanctions on BHP-Billiton and Rio Tinto if they joined their iron ore businesses without first gaining permission from Chinese competition authorities. Ma Yu, the director of the Foreign Investment Department at the Ministry of Commerce's Academy of International Trade and Economic Co-operation stated that 'According to China's anti-trust law, we can veto such a merger agreement if the concentration of overseas business operators will affect domestic market competition'. If the joint venture was set up regardless of China's opposition, Beijing could resort to trade sanctions (Garnaut 2009a). As these two companies both have their mining operations in Australia, following through on such a threat would have ramifications for the Australian economy.

The interesting question is whether such a threat would be regarded as credible by the Australian government (and by Rio Tinto and BHPB). Minister of Resources, Energy and Tourism Martin Ferguson's comments on this at the time suggests the government did not take such a threat seriously, although it was surely also important to play down the significance of the deal's failure:

There is some angst in China (...) to the fact that it fell over is obviously disappointing, but in terms of the future, Australia needs China and China needs Australia. I don't expect to see any trade sanctions (Quoted in Huang and Austin 2012:87).

In the same fashion Treasurer Wayne Swan stated that: 'Obviously any such actions would not be in anyone's best interests including China and many *Chinese businesses that depend on Australian materials*' [Emphasis added] (quoted in Huang and Austin 2012:93). What is worth noticing is how both Ferguson and Swan when assessing the risk of trade sanctions emphasizes the dependence of China on Australian resources.

This raises an interesting point regarding the Australian government's thinking about Chinalco's bid. High attention was paid by other countries around the world, and Beijing put much prestige into the deal's success. Beijing had sought to convince Canberra to approve the deal through a number of diplomatic channels. For instance, on his visit to Canberra 21 March 2009 Li Changchun, ranked as number five in the Communist Party's nine-member Standing Committee³⁹, had two messages regarding Chinalco: 1) the Australian government should let the deal to go through and 2) Chinalco should be given independent commercial status despite being an SOE (Huang and Austin 2012:171). If the Australian government considered aborting the deal it must have occurred to them that the response from the Chinese could have been trade sanctions or other forms of economic retaliation. How did they perceive China's ability to respond economically? Would the Treasury have accepted a more limited deal? It would have been much easier to assess this if the deal had been approved by the shareholders, as both sides would have been forced to show their hand.

5.1.5 Escalating the 'ore wars': Arresting Stern Hu and the breakdown of price negotiations

As explained in section 6.1.3 the iron ore price negotiations themselves were also increasingly becoming a political issue. As has also been established in section 6.1, the Big 3 used their market power for what it was worth. In the 2009 iron ore price negotiations the temperature was turned up yet another notch. 5 July 2009 four employees from Rio Tinto's Chinese iron sales team were

³⁹ The highest de facto decision-making body in China.

arrested by the Shanghai branch of the Chinese Public Security Bureau (PSB). Stern Hu, who was the head of the iron ore marketing team of Rio Tinto and the only Australian citizen in the group, was one of them. Hu had allegedly stolen 'state secrets' on behalf of Rio Tinto by bribing managers of Chinese steel mills for information related to the iron ore price negotiations being carried out at the time, giving Hu's team an advantage in the negotiating process (Wilson 2011a:307). *China Daily* quoted an 'industry insider' saying that Rio Tinto had bribed executives from all the 16 large Chinese steel mills that had participated in the iron ore price talks (Qi and Hao 2009). A spokesman for China's Ministry of Foreign Affairs stated that this had 'hurt China's economic interests and economic security' (Curran 2009). However, Rio Tinto upheld that these allegations were 'wholly without foundation' (Huang and Austin 2012:98).

The Australian government was not notified about the arrests of one of its citizens, was denied consular access to Hu until the 10th of July, and was limited or in some instances denied access even after this point (Wilson 2011a:307). Furthermore Hu was denied access both to an independent lawyer and his family. From the Australian point of view, the process was not reminiscent of a well-functioning legal system. Needless to say it caused an outrage in the Australian media, civil society and political community (Austin and Huang 2012:96-98). Because of the lack of transparency by Chinese authorities in the handling of the arrests, and because Rio Tinto claimed their negotiators were innocent, doubts were raised about whether the evidence had been fabricated. In Australia the arrests were widely viewed as linked to the iron ore price negotiations in some form (Wilson's 2011a:308). As Rio Tinto a month earlier had rejected Chinalco's bid, many also viewed it as Chinese retaliation for the deal's failure. Senator Barnaby Joyce of the Nationals for instance said that:

We know that we're failing to get proper diplomatic access to them, to Mr Stern Hu, and what we can deduct is that there'd have to be a relationship between Chinalco's failure in its purchase of Rio and the ramifications that go beyond a state-owned enterprise all the way to the Chinese Government (Quoted in Glanville 2009).

What implications for the trade relationship?

Even though the arrest itself was carried out by a local branch of the PSB, the investigation that led to the arrest was handled by the Ministry of State Security, and had reportedly been personally endorsed by Chinese President Hu Jintao (Garnaut 2009b). Later *the Sydney Morning Herald* reported that the arrest order had also been signed off by the Communist Party's Standing

Committee (Garnaut 2010a). After arresting Rio's team of negotiators, what would be the next step?

Prime Minister Kevin Rudd avoided commenting on the situation immediately after the arrests. However, there was building up strong domestic pressure on Rudd to involve himself directly. Ten days after the arrest the situation was still unresolved. Information about the circumstances of the arrest was lacking, and the consequences this would have for the broader trade relationship were unclear. Rudd decided to fire off a public warning shot:

'Australia of course has significant economic interests in its relationship with China but *I'll also remind our Chinese friends that China too has significant economic interests at stake in its relationship with Australia* (...) A range of foreign governments and corporations will be watching this case with interest and be watching it very closely, and they'll be drawing their own conclusions as to how it is conducted. It is in all of our interests to have this matter resolved' [Emphasis added] (Quoted in McKechnie 2009).

Rudd was reminding Chinese authorities that (1) escalating this situation any further would be highly economically detrimental to *both* sides, and (2) other nations were watching closely; including the US and the EU. China's reputation was at stake. The comments got the attention of the Chinese leadership, who immediately reassured the Australian government that the case would not represent a threat to their bilateral trade (McKechnie 2009).

Because the Australian government failed to get proper consular access, many Australian commentators at the time argued that the whole process showed how little sway Canberra held in Beijing when push came to shove (Sheridan 2009). The episode indeed displayed that Australia's influence on the situation was very limited, even though Australia as shown in chapter 5 had taken on increasing significance as a supplier of so many resources. However, this is not contrary to what was argued in 5.2: Australia lacked the capacity to put economic pressure on China, and even if it was capable, it is still not likely that it would have wanted to risk escalating the situation further. What these commentators fail to point out is that it seems like the Chinese did not want to escalate the situation any further either.

The charges against Hu were later reduced from bribery and theft of *state* secrets to bribery and theft of *commercial* secrets, with no further explanation of why this was done (Wilson 2011a:307). The trial itself proved to be another contentious issue. Only a very limited part of the trial was open to Australian officials; in breach of a consular agreement between the two countries (Chaffrey 2010). Several Australian ministers including the Prime Minister expressed their strong

dissatisfaction with this, but they did not *demand* full access to the trial; the Chinese side responded by saying that the process was an internal Chinese affair, and that commenting on it was reckless (Garnaut 2010a). As one commentator pointed out Canberra was ‘sending subliminal messages to China that no matter what happens in the trial, it will be business as usual’ (Chaffrey 2010). Hu and the other negotiators later pleaded guilty to taking bribes, received prison sentences of various lengths (10 years for Hu), and chose not to appeal. Even so many in Australia saw the admittance of guilt as a mere formality in a process that was largely predetermined (Huang and Austin 2012:97).

Rio Tinto, who had expressed certainty about their employee’s innocence from the outset, toned down such claims as the months went by. By the end of 2009 Rio was unwilling to make further comment on whether or not Hu was guilty (Leaver and Kelton 2010:266). After the sentences were announced Hu and the others were sacked. Although it seems clear that the initial allegations from the ‘industry insider’ were wildly exaggerated, it seems fairly clear that Hu and the other negotiators were guilty of some sort of unethical behavior (Huang and Austin 2012:99). Perhaps reflecting this, it was later revealed that Rio Tinto had engaged the services of Henry Kissinger to help rebuild the company's relationship with its biggest customer (Garnaut, Needham and Murphy 2010). The curious thing is that both the investigation and the arrests received authorization from the top level of the Chinese government. The fact that they were both handled at the top level is yet another sign of the steel industry’s importance in the eyes of the Chinese leadership. But did the leadership think that the reason why the steel producers were getting unfavorable deals was that they were being systematically cheated by the Big 3 miners? What was going on at the top level remains a mystery even for the best informed journalists (Garnaut 2010b).

Collapse of the iron ore price negotiations

In any case the affair resulted in the collapse of the 2009 price negotiations, as Rio Tinto’s negotiators were all locked up. Indeed, the big iron ore miners argued that the case showed that the pricing system was flawed, and pushed for a more market oriented quarterly pricing structure (Huang and Austin 2012:100) – a solution that had long been promoted by BHPB, and that China was against (Uren 2012). In 2010 the three big miners decided in consultation with the Japanese, South Korean and a few other countries’ steel industries that they would abandon the annual pricing system; the biggest customer, China, had not been consulted. The prices of iron

ore saw massive increases after this point, and the Chinese have continuously expressed their dissatisfaction with the new pricing regime since (Huang and Austin 2012:100).

5.1.6 The result of high prices or a tough line on investments?

After the rush of FDI in 2008 and 2009 Chinese investment flows slowed in the following years by all accounts (Larum and Qian 2012). Until 2008 Australia had accounted for 96 per cent of China's outward FDI in coking coal and iron ore. In 2009-2010 this fell to 34 per cent. Chinese FDI in non-Australian projects for these two minerals went from a total 1 billion USD in the whole period of 2002-2008 to 11 billion USD in the years 2009-2010 (Wilson 2011a:275-276). Chinese SOEs have instead invested heavily in iron ore projects in West and central Africa (Hurst 2012), and in South America.

Reilly (2012a:390) quotes interviews with Australian businesspeople working with Chinese mining companies, insisting that the new regulations *have* had a limiting effect on Chinese investment. According to Drysdale (2012) Chinese investors have suspended investments in large magnetite projects in WA because of the new guidelines⁴⁰. More specifically a major new project, the Oakajee port and rail is seen as the key to opening WA's magnetite-rich region, is dependent on Chinese companies as equity partners (Hurst 2012:9). The Australia-China Business Council also report that Chinese investors feel discriminated against as a result of the close scrutiny in general (Larum and Qian 2012:9).

However, other factors are probably as important to explain this. First, the government funding provided for outbound FDI had resulted in something of an investment-bonanza on the part of Chinese SOEs in the favored sectors. In the process 'some high profile poor deals' had been concluded (Larum and Qian 2012:9), in Australia particularly Chinese steel company CITIC Pacific's Sino Iron project in WA, that to date has gone AU\$ 7.4 billion over budget and has been labeled a 'disaster' (Garvey 2012). As a result the NDRC, who approves applications from Chinese companies, began to scrutinize the deals closer to ensure their commercial viability (Uren 2012:80).

Second, high and growing labor costs in Australia, partly a result of the fast restructuring of the economy, is one factor that these SOEs have to take into account. Part of the expectation that the Chinese had when they started FTA-negotiations with Australia in 2005 was that that Chinese

⁴⁰ Magnetite is a form of iron ore found in the mid-west of WA; the iron ore projects in the north are based on hematite.

companies would be allowed to bring in their own workers (Ravenhill and Jiang 2007:9). That would mean that the Chinese companies would bring in workers on terms dictated by the companies rather than by local wage bargaining, a practice that Chinese companies to a large degree have been allowed in African countries. According to one respondent ‘that is about as dangerous a red flag as you can possibly wave to the labor movement’⁴¹, something that was confirmed in an interview. The demand has not been met by Australian government, although in recent years there has been some few exceptions to this rule, allowing companies to fly in workers for some specific projects (Beeson, Soko and Young 2011). It might also be that the new mining tax that was eventually introduced in 2012 has had some effect on investment (Huang and Austin 2012:190).

Recall the Liberal Party Senator of WA that told the story of Ambassador Fu Ying and others demanding that the government took issue with the pricing of iron ore. The Senator continued:

Nobody took the threat too seriously, but now the Chinese are investing in West Africa very heavily in iron ore. They are diversifying their supply base partly in response to the ever-escalating prices, which the Australian miners had been charging (...) China has lots of options and we really only have one, and that is China. If we are not sensible about prices the Chinese really will go elsewhere (Interview with Alan Eggleston, Senator of the Liberals).

This seems also to be a factor. Investing in and importing from other countries including countries in West Africa, countries in South America and in India is part of the Chinese government and companies’ long term strategy to ‘break the dominance’ of the Big 3 miners in iron ore. However, the Australian economy as a whole is in no way dependent on Chinese capital. Even though there was a significant growth in Chinese FDI, in 2008-2009 Chinese investment still ranked tenth in investment levels by country. In 2011, China accounted for less than 3 per cent of FDI stock in Australia (Larum and Qian 2012:6)⁴². Nor is the mining industry dependent on Chinese FDI. British, American, Japanese and South Korean enterprises continue their dominance of the Australian resource sector, raising their capital in international markets (Huang and Austin 2012).

Wilson (2011a:275) asserts that ‘because of the limited scope for strategic behavior it allowed, the 2008 [foreign investment] regime may have somewhat quelled China’s appetite for investment in Australian iron ore and coking coal projects’. By this he means the kind of mega-deals that were outlined above. These have a large impact on total FDI numbers. For instance, if the Chinalco-

⁴¹ Interview with John Ravenhill.

⁴² Accumulated FDI.

Rio Tinto deal had been approved the result would have been an increase of 36 percent in *total* Chinese outward FDI in 2009 (Lan et al. *forthcoming*). These deals were also what the government was most worried about, so the change in pace may have been viewed in Canberra as a relief.

In terms of trade flows the Chinese strategy of diversification has not succeeded yet. In 2011 China imported iron ore from 58 countries (Dou 2012), but still as shown in chapter 5 imported about 70 percent from Australia and Brazil. And Vale BHPB and Rio are as dominant as ever. Also, how successful these new projects in West Africa and other places where the Chinese steel producers have invested heavily will depend much on the price of iron ore in coming years. This again depends on whether or not the Chinese demand continues to grow, and how fast the new supply will come onto the market. Meanwhile, Australia is expected to produce 758 million tons a year by 2016 (up from 439mt in 2011) (Jamasmie 2012). Most of this growth will come from BHPB and Rio Tinto as well as FMG. BHPB expects to increase its output to 240 mt by 2013 in Western Australia, while the Rio Tinto expects to increase to 330 mt by 2015. Also, FMG has plans to increase to 155 mt in the future (Huang and Austin 2012:191). While this and a range of mines being developed in West Africa means that prices will potentially fall soon, impacting negatively on the price of iron ore and Australia's overall terms of trade and government revenue (Hurst 2012), the expansion in volume can make up for at least some of it.

5.1.7 Divergent business interests and political opposition against Chinese FDI

In this section I will look at whether or not the mining lobby has influenced the government's decisions in the two conflicts that have been the subject of this subchapter. First off, in relation to the pricing of iron ore one there is no common interest among the Australian miners and China – the miners naturally want the highest possible price for their product, and want markets to set prices, and that is about all there is to say on the matter. Second, there seems to be no unified front amongst mining companies in Australia with regards to the question of investment from Chinese SOEs. Rio Tinto has argued publicly that the government should be more welcoming to Chinese FDI, while BHPB has taken the opposite view – in both cases their stance in the debate seem to reflect the strategies of those particular companies. More generally it seems like many companies view the Chinese SOEs as having an unfair advantage because they are more often than not backed by discounted loans from their home government. The inflow of Chinese FDI also spurred a heated political debate, with the public opinion very negative towards increased Chinese ownership in the Australian resources sector.

Divergent business interests

As shown, in 2008 Chinese FDI flows into the Australian resource sector seriously took off, and Canberra introduced new FIRB guidelines for SOEs. Rio Tinto took the view that the Australian government should be more welcoming towards Chinese FDI and ease the investment rules for SOEs (Wilson 2011a:273). In 2008 Rio Tinto's chief executive Tom Albanese said that:

Australia should build stronger linkages with its most important growth markets through continually improving trade relationships. This may include being more flexible in accommodating the needs of customers, including taking ownership stakes in existing and new resource producers (Albanese 2009:12).

Rio Tinto had, as shown, specifically sought out Chinese investment. In addition the company viewed China as the biggest future market. The Australia-China Business Council and several investment banks also took this approach (Wilson 2011a:273). BHPB on the other had not specifically singled out Chinese investment, and was at this time itself interested in a takeover of Rio Tinto. Already on the day after Chinalco's announcement that it would buy a 9 per cent stake in Rio Tinto, BHPB's chair and chief executive held meetings with Kevin Rudd in Canberra (Uren 2012:72). After the new FDI guidelines were proposed BHPB argued publicly that the government's new investment regime was very reasonable (Wilson 2009), and that it was in Australia's national interest to have 'national champions' (Uren 2012:72). FMG arguably held the middle ground; it has been shown that they expressed reservation in instances where Chinese SOEs would get too much control. CEO of FMG Andrew 'Twiggy' Forrest boasted that Hunan Valin's investment in FMG should serve as a yardstick for future Chinese investment, as it demonstrated 'how China in a friendly way, in a minority way, in a totally non-controlled way, in a passive way, can invest in our operations without influencing the independence, direction or sovereignty' (Eastley 2009). However, according to several news polls in 2010 the broader Australian business community was skeptical to Chinese SOEs buying up Australian companies (Wilson 2011a:273).

The division between BHPB and Rio Tinto became more pronounced over the course of 2008 and especially into 2009, when the Chinalco-Rio Mark II deal was proposed. In fact all three companies – Rio Tinto, BHPB, and Chinalco – ran intense lobbying campaigns directed at the government to influence the Treasury's decision on whether or not to approve the bid.

Rio Tinto's campaign worked on two levels: the first part was a lobby-campaign towards the government and in the media arguing that the deal was not going to have any implications for China's control over prices, and that there was no China Inc. Secondly, they threatened that not approving the deal would force them to cut down 2150 existing and 750 planned jobs in Queensland – the home state of Prime Minister Kevin Rudd and Treasurer Wayne Swan. Chinalco hired an Australian lobby firm, Hawker-Britton, which had a large network of contacts in the Labor Party – this firm that had also assisted Chinalco in its campaign to win support for the first deal. The aim of this campaign was to 1) lobby the Australian government to accept the deal and 2) test the governments view about how much the deal had to be altered for them to accept it. However, BHPB's lobbying campaign was arguably the most effective. Their government relations team consisted of former top Labor party people (Huang and Austin 2012:147-160). One government official said later said that 'e-mails from BHP were circulating at the highest levels, about all the 'China Inc.' stuff' (Garnaut 2009c).

However, over the course of the 90 days of scrutiny by the FIRB, Rio Tinto's board found that they lost the support from the shareholders (in London). Many of them had been unhappy about the deal from the outset, claiming that the board had given away too much and was selling when markets were at the bottom. Some of them criticized the board's decision publicly (Webb and Finch 2009). As markets started to pick up, the deal looked even less favorable, and it was ultimately abandoned.

The Australian business community was according to Huang and Austin (2012:83) very negative towards the fact that Chinalco had access to state financing – something that Chinalco and Rio Tinto when announcing the deal had presented as a positive – viewing it instead as an unfair commercial advantage (Ibid).

Public and political opposition

What is especially interesting in relation to the first Chinalco bid is that it for the first time highlighted the possibility that prominent Australian companies could become part or wholly owned by Chinese SOEs. Reflecting this, the yearly Lowy Institute poll conducted in 2008 included several questions related to direct investment by SOEs and SWFs. Two of these are interesting for the purpose of this study. First, 85 percent of respondents either 'strongly agreed' or 'agreed' that 'investment in Australia by companies controlled by foreign governments should be more strictly regulated than investment by foreign private investors'. Second, 78 per cent of

the respondents opposed investments from Chinese government-controlled entities aimed at buying a controlling stake in any major Australian company (Hanson 2008:6).

So when Chinalco launched its second bid in 2009, the political response was enormous. Representatives of the National Party and the Greens initiated a political campaign to press the government to reject the bid, including through a TV advertising campaign and a petition (O'Brian 2009). The leader of the Australian Greens, Bob Brown was quoted saying that: 'It is hazardous for the Treasurer to entertain the proposed deal between Rio Tinto and Chinalco when the Communist dictatorship will be pulling the strings behind the scenes' (Darnbrough 2009). Even the opposition leader at the time, Malcolm Turnbull of the Liberals, stated publicly that Treasury should reject the bid:

The Chinalco-Rio transaction should not be approved in the form in which it has been presented (...) The object of Chinalco's acquisition is plainly strategic. This will give Chinalco, and hence the Chinese government, the seat of greatest influence and access to information about costs, pricing and marketing strategies (quoted in Daley and Keenan 2009).

According to a news poll conducted in April, six out of ten Australians wanted the government to block the bid, while only three out of ten wanted government to approve it (Taylor 2009).

The Greens' leader also forwarded a motion in the Senate to block the bid, but it was voted down. Instead a new motion was forwarded in the Senate, suggesting that the Economics Committee make an inquiry into foreign investment by state owned entities (Economics References Committee 2009a). The Committee started the inquiry into foreign investment by SOEs and SWFs in early 2009, assessing whether Australia's current foreign investment regime was *sufficiently restrictive* in light of rapidly growing Chinese investment. The report looked at the challenges that arose in relation to Chinese investments, but concluded that the investment regime was sufficient. However, three of the Senators participating in the inquiry concluded that the foreign investment regime was not sufficiently restrictive, and wrote a dissenting report. In addition to the concerns already noted, the dissenting report argued amongst others that the human rights record of the owner be taken into account by the FIRB.

China's approach to human rights is in stark contradiction to Australia's stance and should as such be a factor of consideration when assessing whether to allow the government of China, through its state-owned entities and sovereign wealth funds to benefit from Australia's successful industries and economy (Economics References Committee 2009a:70-71).

This issue is especially important to the Australian Greens⁴³.

It also instigated a broader debate about foreign ownership in the Australian resources sector. The Australian Greens published a discussion paper with arguments reminiscent of those made during the 1970s, when Australia nationalized its resources sector (Edwards 2011). A new round of debate followed over Australia's agricultural sector after a Chinese consortium bought Cubby Station, Australia's largest cotton farm, in 2012. This spurred a new Senate inquiry (Rural and Regional Affairs and Transport References Committee 2012), and the Coalition (the Nationals and the Liberals) put forward a new discussion paper on foreign investment in the agricultural sector proposing that the FIRB review any acquisition of agriculture land valued at AU\$ 15 million or more regardless of country background (Liberal Party of Australia and National Party of Australia 2012)⁴⁴. The 2012 Lowy poll showed that this was an issue that Australians were particularly concerned about: 81 percent of the respondents said they were against the Australian government allowing foreign companies to buy Australian farmland to grow crops or farm livestock (Hanson 2012).

It seems that Chinese state ownership has become something of a domestic political issue. Right before a recent visit to Beijing, the Australian opposition leader Tony Abbott stated in an address to the Australian Chamber of Commerce that: 'Chinese investment is complicated by the prevalence of state-owned enterprises. *It would rarely be in Australia's national interest to allow a foreign government or its agencies to control an Australian business* [emphasis added]' (quoted in Callick 2012).

Some of the politicians that were interviewed for this thesis were critical towards those who took the most hardline positions on Chinese FDI (such as for instance Barnaby Joyce of the Nationals). Some of the respondents (from the Liberals and Labor Party) argued that the debates about foreign investment had a tendency to become overly emotional. Alan Eggleston of the Liberal party, who participated in the Senate Economics Committee's *Inquiry into foreign investment by SOEs and SWFs*, said that:

There are other state owned enterprises that operate in Australia that haven't proven a problem. I suppose it is a bit revealing of the Australian psychology to some degree; here we are with a small population of 23 million; and there is China with 1.2 billion people. People might fear that through these state owned enterprises that they will somehow take over Australia. But I don't think that is a reasonable concern (Interview with Alan Eggleston, Senator of the Liberals).

⁴³ Interview with John Hawkins.

⁴⁴ Although there was an exception for countries that Australia had special arrangements with. Most notably the US negotiated higher FIRB thresholds through the two countries FTA.

He argued furthermore that both in his own party and in the other parties there was an East-West divide: politicians from WA tend to be more positive towards foreign investment from China, because they have seen the benefits that it has brought to their state historically and therefore also can bring in the future in terms of jobs and money. But the Labor and Liberal party Senators were more concerned about the *tone* of the debate and were afraid that the investment regime would become more restrictive – they thought the current regime worked pretty well.

There is little pointing towards an easing of Australian FDI regime. When the FTA negotiations fell over this year, both sides agreed that they would instead seek try to agree on a more trimmed-down deal focusing on the most critical issues for both parties. Left with one claim, China chose to demand that the FDI limit for Chinese SOEs was increased from zero to a billion (which is the deal the Americans got for private companies through the FTA), while Australia wanted better access to the Chinese agricultural market. However, this was not a deal that Canberra was willing to make. Commenting on the Chinese proposal, Trade Minister Craig Emerson said that: ‘Now, we can't do that. *The community would not accept that*’ [Emphasis added] (Callick and Kitney 2013). In this statement he also highlights a key point: it seems that the public and political concerns weigh heavier for Canberra than any attempts by businesses to lobby one way or the other.

Summing up, there is no common interest between China and the mining companies with regards to price. There has been no unified position between the Australian companies with regards to Australia’s foreign investment regime. It is worth noting that the only ones who have explicitly lobbied the Australian government for Chinese interests either had particular interest in the outcome (Rio Tinto) or was paid handsomely for their effort (Hawker-Britton). There was also intense public and political opposition to Chinese FDI, something that is seemingly more important to the Australian government than attempts by business interests to convince them to reconsider.

5.1.8 *Summary*

This subchapter has highlighted some of the economic conflicts that have arisen as China and Australia have expanded their trade during the 2000s. I have looked two areas where there has been much disagreement between the parties: the pricing of iron ore and Australia’s investment regime. In the first conflict, Beijing initially wanted Canberra to interfere with the pricing of iron

ore, but the Australian government declined to get involved. Beijing could not force them to accept an outcome they did not want. The iron ore price negotiations grew more intense year after year, before Stern Hu was arrested in Beijing during the 2009 iron ore price negotiations. Though the motivation for this is still unclear, both sides restrained themselves from escalating the situation further. The outcome that ensued, the collapse of the annual iron ore price negotiations, was pushed through by the big 3 miners but nonetheless unfavorable to China's interests as their leaders perceived them. In the second conflict, the sudden increase in FDI in Australia's resources sector following Beijing's ambitious foreign investment plan were met with new guidelines for FDI from SOEs and SWFs. Though it is unclear how comprehensive these regulations were in practice, it seems they were intended to strike a balance between the benefits of FDI and the possibility that Chinese SOEs might seek to manipulate prices to the benefit of their home government and particularly the steel industry. Following the collapse of the Rio Tinto-Chinalco deal partly as a result of the lengthy FIRB review process, and the announcement of a merger between BHPB and Rio Tinto's iron ore operations, the Chinese government threatened with trade sanctions against Australia's two biggest miners if they went through with it. From the comments made by some Australian Ministers, it is not likely that these threats were regarded as credible – although these ministers surely also tried to downplay the significance of the threat. Although the Chinese government started pushing for an easing in Australia's investment regime in FTA talks in 2008, the Australian government has not budged. The reason why they have not budged seems to be mostly the fear that Chinese SOEs might gain too much control over pricing of key commodities, but also to some degree the intense political pressure on them.

5.2 Economic and Defense Interests Colliding?

Tow points out that when assessing the relationship of the China and Australia, one cannot get around also looking at the 'curious mixture of benefits and tensions flowing from each party's relationships with the US' (Tow 2004:51). In this section I will look at the tensions that stem from the fact that Australia has an alliance with the US, while China's relationship with the latter is complicated.

I will not attempt to categorize Australia's behavior in terms of 'hedging', 'balancing', 'bandwagoning' or the like, but rather look at whether the decisions that Australia has made have been the result of economic pressure from China. In certain respects Australia has shown consideration to Chinese interests (in line with Reilly 2012; Manicom and O'Neil 2010). Such

instances include the Howard government's positive public depiction of China, the Rudd government's decision to withdraw from the Quadrilateral Dialogue and the decision by the Labor government not to send any Ministers to Taiwan. But this does not appear to have been the result of Chinese economic pressure to do so. Contrary to White's (2005a:479) claim that Australia has 'acquiesced to China's demand that a strong economic relationship is conditional on a measure of compliance with Chinese wishes on key political and strategic questions', it is argued that these decisions have been made according to what is perceived by decision-makers to be in Australia's interests. Furthermore there seems to be little interest by business interests to lobby Canberra over such issues.

5.2.1 The interests of the two parties

Implicit in debates about Australia's 'strategic alignment' and China's new economic importance ('the China choice') is that it is important for China that a close trading partner like Australia is also an ally. Based on the interviews with former diplomats and senior officials it seems that this assumption does not entirely hold water. Geoff Raby, who was deputy secretary in DFAT from 2002-2006 and was ambassador to China from 2007-2010, said that:

The Chinese are pragmatic in their foreign policy. They accept the alliance; it's a fact of life for them. (...) They have highly skilled ambassadors and clever diplomats that every day are reporting that Australia-US security relationship is rock solid, will never change and can never change. There are only so many times you want to hear that (...) They could threaten us with nuclear weapons and it still wouldn't change (Interview with Geoff Raby).

From the period under review it does not seem to be a high priority from the Chinese side that Australia ditches its alliance with the US. First, it would only be a symbolic victory, as Australia's military capacity to make a difference in the regional power balance is minimal⁴⁵. Second, how much effort will China put into convincing one of the US staunchest supporters to reconsider its alliance? This is important to keep in mind, because the importance of the issue should also determine how willing China is to apply economic pressure. What concerns Chinese authorities more seems to be depictions of China as a threat to the regional stability, and what Beijing regards as attempts to contain its military influence. Furthermore, a very sensitive issue is the status of Taiwan, which is still seen to be an integral part of China. When the People's Republic of China was established in 1949 it laid claim to Taiwan, and any country that establishes relations with China has to acknowledge in some way that the government in Beijing is the one

⁴⁵ This argument was made by Geoff Raby.

true government of China, and cannot seek official diplomatic relations with Taiwan (Mackerras 23-24). Whether or not governments make official representation to Taiwan is consequently a very important question to Beijing. Furthermore, in the early 2000s as there was the question about whether or not the ANZUS alliance between the US and Australia would also apply to Taiwan.

The quote above also reflects the importance of the US alliance to Australia. The ANZUS alliance with the US has been the cornerstone of its defense policy since the end of the Second World War. US presence in the region has provided Australia with security, and continuing close defense cooperation is therefore Australia's a highly prioritized foreign policy goal. This does not mean that it is in Australia's interest to always and at all times do as the US tells them to. Because of its increased economic dependence on China economically Australia also has an interest in decreasing the possibility of conflict in the region more generally and between China and the US specifically.

5.2.2 The Howard years

In this section it will be argued that what Australia was trying to do under Prime Minister John Howard was to show its commitment to the alliance with the US, expand trade with China, and at the same time make the chances of a major conflict between China and the US as little as possible by projecting a positive image of China.

During the years under Prime Minister John Howard there was little public animosity. His period got off at a chilly start in 1996 when Clinton decided to send carriers into the Taiwan Straits to respond to Chinese missile attacks towards Taiwan, and Australia supported the US. But from this point relations improved significantly throughout the rest of the Howard years. The Howard Government's public depiction of China was very positive; from describing the two countries relationship as an economic relationship in 1996; an 'economic relationship with strategic significance' in 1997; a 'strategic economic relationship' in 2003; to describing it as a 'strategic relationship' in 2004⁴⁶. The 'warmth' of the bilateral relationship arguably reached a high point in 2003 when Hu Jintao was also allowed to visit the Australian Parliament, shortly after Bush (McDowall 2009).

⁴⁶ The Australian government on several occasions expressed that it did not necessarily adopt the Bush government's characterization of China as a 'strategic competitor'.

Furthermore, under Howard Australia declined to join the US and Japan in pressing the EU to maintain its arms embargo on China, and also refrained from joining US criticism of China's military buildup. Was this as White (2005a:470) suggests signs that Canberra was forced to comply with Chinese demands that 'a strong economic relationship is conditional on a measure of compliance with Chinese wishes on key political and strategic questions'? In a speech in August 2004 Howard said that Australia's relations in Asia were not dictated by its relationship with the US but by its own national interest. Four days later Foreign Minister Alexander Downer was in Beijing to meet with Chinese Premier Wen Jiabao. When the meeting was concluded the two did a joint press conference (Uren 2012:115). While saying nothing about what they had agreed to in the meeting⁴⁷, Downer told the media:

With Premier Wen we agreed that Australia and China would build up a bilateral strategic relationship, that would strengthen our economic relationship and we would work together closely on Asia-Pacific issues, be they economic or security issues (quoted in McDowall 2009:34).

When asked by the Sydney Morning Herald a hypothetical question about what the Australia would do in the event that there should be a conflict over Taiwan, Downer replied:

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 (quoted in McDowall 2009:34)⁴⁸.

These statements immediately spurred negative reactions from the US through diplomatic channels, and quite a stir in Australia. Hugh White for instance wrote that 'Downer made it absolutely clear that if the US and China went to war over Taiwan, Australia would prefer to stay on the sidelines', even going as far as claiming that 'now we are closer to Beijing than to Washington' (White 2005b). Howard soon had to correct Downer. But McDowall (2009:35) argues that this was not a mere 'slip of the tongue': 'the statements came hand in hand: a reduction of ANZUS to a highly symbolic status, coupled with a fundamental reorientation of Australia's strategic posture towards China'. Manicom and O'Neil (2010) also find it hard to believe that this was not a calculated move, citing his eight years of experience as Minister. White's (2005b) account at the time left the impression that economic pressure from China had forced Canberra into reversing its position on Taiwan: 'Of course we all know why. China is seen

⁴⁷ At this meeting Downer told Wen of a cabinet commitment to begin talks about a bilateral FTA; Wen in return told him that Beijing wanted to buy Australian uranium (Leaver and Ungerer 2010:7).

⁴⁸ It should be noted that Downer himself complained that he had been misquoted (Uren 2012:117).

as the key to Australia's economic future, and *Beijing has made it clear that economic opportunities are conditional on strategic and political alignment?* [Emphasis added] (White 2005b).

It is not impossible that these scholars know something that the author does not. But the evidence seems to be slim that Downer intended to sow doubts about the ANZUS treaty itself or that this was a result of threats on the part of the Chinese. The message he was trying to convey was that if a conflict occurred the response of Australia would depend on how that situation came into being: 'For instance, if China acted unilaterally in order to challenge US authority we would join, but if Taiwan acted unilaterally we wouldn't join'⁴⁹. Who was the message aimed at? First, his response was partly a warning directed at authorities in Taiwan, where some political forces at the time wanted to pursue independence unilaterally, that Australia would not necessarily defend them. US authorities were privately conveying the same message to Taiwan; they would not provide back-up if Taiwan acted unilaterally (Uren 2012:117-118). Second, the government wanted to make sure that the Americans knew where Australia stood:

It was something that I felt myself had to be said at some stage, because some Americans, particularly the Bush-Cheney people, had an unrealistic expectation that no matter what the circumstances where; if there was conflict between China and US over Taiwan, Australia would come down on the side of the US (...) The problem was that Downer said that in Beijing. That's a great pity. In my opinion he was right to say it, because as a good friend of the US we need to make sure that they know our interest are different. They overlap, but they are different. And there are situations where the Australian community would never accept action against China. That has to be clearly understood (Interview with Geoff Raby).

As for Howard's use of the word 'symbolic', it seems McDowall reads too much into it. That the ANZUS alliance was reduced to a '*highly symbolic status*' [emphasis added] is McDowall's own interpretation.

There have been no reports of the Chinese threats that White (2005b) name as the reason for the statements. In the talks with Wen and his team earlier that day neither Taiwan nor ANZUS had been mentioned (Uren 2012:117). Besides the account given by Geoff Raby, the other former diplomats and Senior Government Officials in DFAT that were interviewed made it clear that it was unrealistic that Australia would have given in to such threats. There is no doubt that the Chinese were happy about the statements, but it was only afterwards (in 2005) that they probed through diplomatic channels into the possibility of Australia reconsidering its ANZUS commitments, formally exempting a Taiwan contingency from any alliance application. However,

⁴⁹ Interview with Geoff Raby, who was deputy secretary in the DFAT at the time.

these suggestions were ‘politely and firmly refused by Australian Officials’ (Scobell 2007:88). Siracusa (2006:47) writes about the situation that ‘if Australia followed the United States into conflict with China, the Chinese could cease bilateral free-trade talks and use their influence to lock Australia out of emerging regional bodies, economic groupings, and political associations’. That is a highly uncontroversial statement that highlights the point. What Canberra was trying to do was reduce the risk of such an event.

There can be no doubt about the Howard Governments commitment to the ANZUS alliance; Australia had invoked it for the first time after the September 11 2001 attacks, and was fighting alongside the US in both Afghanistan and Iraq. Australia committed 1500 soldiers to the invasion of Afghanistan, and unlike most allies of the US these force levels were sustained throughout the decade. Australia was also an early supporter of the US-led war in Iraq, committing some 2,000 soldiers despite vociferous domestic criticism (Reilly 2012a). Nor can there be any doubt that Australia wanted as close a relationship with the US on the security front as possible. When Australia concluded its FTA with the US in 2005 it was widely viewed as very unfavorable to Australia in terms of market access (Weiss, Thurbon and Mathews 2004; Ranalds 2006). Key agricultural sectors for Australia were excluded from the agreement (wheat, meat and sugar), while the US got free access to Australia’s service sector. The deal was so bad for Australia economically that even its own trade negotiators advised against signing on (Beeson 2007:601). A year after the conclusion of the FTA Australia’s trade deficit with the US had increased by US\$1.3 billion in the twelve following months. Australia’s exports to the US fell by 4.7 per cent, while US exports to Australia rose by 5.7 per cent (Ranalds 2006). But in exchange Australia was promised closer security cooperation with the US (Reilly 2012a:380). Summing up the US-Australian alliance under the Howard government, Beeson (2007:1) noted that ‘no ally of the United States could claim to be more enthusiastic, reliable or obliging than Australia’.

Simply put, that the government spoke in positive terms about relations with China is not surprising. But that does not mean that Australia considered breaking the ANZUS commitments that had guaranteed its safety for the past 50 years, nor that the statements were a result of Chinese economic pressure to do so. Previous Australian governments had taken an equally pragmatic approach. Under the Hawke government (1983-1991) for instance the *tone* was good – but this did not stop the government from bugging the Chinese embassy in Canberra in the early 1980s. It would be naïve to think that the Howard government was not uneasy about the relationship. Howard expressed his ambivalence to the relationship on several occasions, but defended the approach of separating between the economic and the political realm:

China is still an authoritarian state and I have no false illusions about that. But I also have no false illusions about the national interests of my country and the national interest of my country suggests that the development of a strong economic relationship with China is good and I'm unapologetic about that (quoted in Zhang 2011:75).

Towards the end of Howard's term he aligned Australia with the Quadrilateral Security Dialogue in 2007. The dialogue was initiated by Prime Minister of Japan Shinzo Abe, with the support of US Vice President Dick Cheney, Indian Prime Minister Manmohan Singh and John Howard. The dialogue was followed by large joint military exercises between these four countries, and the arrangement was widely viewed as a response to increased Chinese economic and military power (Tow 2008:22). The idea of the Quad was to be an 'Asian Arc of Democracy', an alliance of democratic countries in the region (Twining 2007). According to one respondent 'it sent China nuts, because although they can understand various regional groupings, if it is based around democracy they see that as an ideological anti-China grouping, which of course it was'⁵⁰.

Beijing saw it as an attempt to 'contain' China's military influence in the region. Subsequently, China sent diplomatic notes to all four countries seeking clarification of the development, and launched a concerted diplomatic campaign against it. Chinese Officials stated that it reflected a cold-war mentality, and that they saw it as a 'formation of a small NATO to resist China' (Tow 2008:22). The Australian foreign affairs department subsequently assured China that the Quadrilateral dialogue would not work as a security alliance (NYT 2007).

5.2.3 Multilateral engagement with bilateral vigor

Upon resuming office the Rudd government quickly reaffirmed its strong support for the US alliance as a fundamental component of Australian foreign policy (Tow 2008:39). Rudd also quickly decided to pull Australia out of the Quadrilateral Dialogue. The decision was announced by Foreign Minister Stephen Smith at a joint press conference with Chinese Foreign Minister Yang Jiechi (Nicholson 2008). This decision has often been cited as an example of Australian accommodation of Chinese interests, but even so there is no indication that the decision was the result of Chinese economic pressure. Rather, it seems that the decision was made so as to avoid making the regional situation unnecessarily tense. And with or without the Quadrilateral Dialogue, Australia has strengthened its security ties with Japan throughout the period: with the *Japan–Australia Joint Declaration on Security Cooperation* in 2007 as one example, and also increasing

⁵⁰ Interview with Geoff Raby.

military cooperation. Australia has also strengthened security ties with India and South Korea (Reilly 2012a:381-383).

The same can be said about the Rudd government's decision not to send any ministers to Taiwan. Between 1983 and 2007 Australia did not go through one parliamentary term without sending a government minister to Taiwan (Reilly 2012a:391), and as explained in 5.2.1 this is a particularly sensitive issue to China. The Rudd government decided not to send any ministers to Taiwan. However, this must also be read into the Rudd government's perception of the regional security situation. Relations between China and Taiwan were growing tense at this point, something that worried Rudd. In a speech in 2008 he argued that Asia-Pacific region was about to become more militarily contested, and specifically mentioned Taiwan (Zhang 2011:88).

Despite these two examples, the Rudd government would not make a habit out of 'accommodating' Chinese interests in its defense-choices. China had been investing heavily in building up its blue-water naval capability over the 2000s. This had not been a major concern in the last three White Papers that came out of the Defense Department (2000, 2003 and an update in 2007). The Defense paper of 2000 stated that: 'No country in the world will have the military or economic power to challenge US global primacy over the next few decades' (Defense 2000:8). Even so there were some concerns about the relationship between China and the US, as has already been explained:

Significant problems remain in the relationship - especially concerning the issue of Taiwan. It is therefore possible that US-China relations may be a significant source of tension in the region in coming years (Defense 2000:18).

On the whole, however, the White Paper was optimistic. The 2003 White paper was even more optimistic, stating that 'the threat of direct military attack on Australia is less than it was in 2000' (Defense 2003:9). In relation to China it read:

Despite tensions early in 2001, US-China relations have stabilized. But strategic competition between the US and China will continue over the next decade, and the possibility of miscalculation over Taiwan persists.(Defense 2003:8).

The 2007 update struck a more cautious tone, pointing out that the 'pace and scope' of Chinese military modernization could create 'misunderstandings and instability in the region' (Defense 2007:19). The 2009 White Paper, *Force 2030*, continued along this path:

The pace, scope and structure of China's military modernization have the potential to give its neighbors cause for concern if not carefully explained, and if China does not reach out to others to build confidence regarding its plan (...) If it does not, there is likely to be a question in the minds of regional states about the long-term strategic purpose of its force development plans, particularly as the modernization appears to be beyond the scope of what would be required for conflict over Taiwan (Defense 2009:34).

In addition the white paper also had many references to an unnamed 'major power adversary' (Defense 2009:64, 65) and similar terms, something that was widely read as code for China. In its second part, the white paper then 'proceeds to recommend the largest peacetime defense expenditure since World War II and lists as future procurements three air warfare destroyers, eight frigates, and twelve conventional submarines' (Thayer 2011). Before the white paper was published it was presented to Chinese Officials. The official story was that the Chinese had no objections. However, it was later revealed in leaked US diplomatic cables that the Chinese had demanded changes to the document – particularly the part about 'China's military build-up being beyond the scope required for any conflict over Taiwan'. If they did not, they would 'suffer the consequences' (Dorling and Baker 2010). But as noted by Reilly: 'Despite Beijing's veiled economic pressure, however, Canberra held its ground' (Reilly 2012a:19).

Any doubt about which country the paper was referring to disappeared when a diplomatic cable containing a conversation between US Foreign Minister Hillary Clinton and Prime Minister Kevin Rudd was made public through Wikileaks the following year. In the cable Rudd states that he is a 'brutal realist' on China. When Clinton asks him in all seriousness a question that goes to the core of the US problem with China: 'how do you deal toughly with your banker?', he answers that the way to approach China is 'multilateral engagement with bilateral vigor'. That is, try to engage China multilaterally and give it room to demonstrate that it is a responsible stakeholder, but prepare 'to deploy force if everything goes wrong' (Kelly 2010). Despite giving a glimpse into the thinking of the Rudd government, the cable shows yet again the extremely close relationship between the US and Australia.

Defense concerns over Chinese investments

With China, on the contrary, there seems to be little trust in the security realm. Canberra seems deeply suspicious about Chinese intentions. As mentioned in section 6.2 there was more than one reason for the new FDI rules. There seems to also have been a concern that some Chinese SOEs might do their government's bidding in this issue area.

The Australian Treasury has made two decisions to limit Chinese investments on national security grounds. In 2009 the Treasury blocked China Minmetals from acquiring Australian mining company Oz Minerals because one of its assets, Prominent Hill, was too close to a sensitive military facility. The Woomera Defense zone – used to test guided missiles, unmanned air vehicles and electronic warfare systems – was about 150 kilometers from the mine. However, a subsequent deal was agreed whereby Minmetals agreed to purchase all of the assets of OZ Minerals with the exception of Prominent Hill (Drysdales and Findlay 2009:363). Later the same year Wuhan Iron and Steel Corporation had to withdraw its bid for a 50 per cent share in Western Plains Resources, because the mine it was purchasing was also too close to the Woomera area (Huang and Austin 2012:65). According to the Australian Defense Department the investment would ‘not be compatible with defense's activities at the Woomera Prohibited Area on safety, operational and national security grounds’ (Kwok 2009).

5.2.4 American troops in Darwin, Huawei and the 2013 Defense white paper

When Julia Gillard took over as Prime Minister in 2010, she also immediately doubled down on the alliance with the US. In November 2011 it was announced that 2500 US troops would be stationed at Darwin, located along the coast of the Northern Territory. It was widely regarded as a part of the US ‘pivot’ back to Asia. A Chinese Foreign Ministry spokesman commented that ‘It may not be quite appropriate to intensify and expand military alliances and may not be in the interest of countries within this region’ (Calmes 2011). There has been no mention of any economic retaliation.

Furthermore, in 2012 the Chinese technology company Huawei was banned from participating in tenders to supply equipment to the national broadband network (NBN) because of concerns over cyber-attacks originating in China. The Australian Security Intelligence Organization (ASIO) and the Defense Signals Directorate advised government that there was a ‘serious risk’ that the Chinese government could access the \$36 billion NBN if Huawei was involved in its construction (Kirk 2012). A number of other Western countries including the UK have let Huawei participate in tenders, and in China the decision was widely viewed as a result of American pressure on the Australian government (Larum and Qian 2012:11). However, there is not enough evidence to conclude whether or not this was a factor. Huawei hinted that the Chinese government would retaliate strongly against Australia if the ban on the company’s tenders was not lifted. Even so, Australian Prime Minister Julia Gillard stood by the decision (Barker and Ramli 2012).

The Gillard government's 2013 defense white paper on the one hand reconfirms that Australia will serve as the base for the US pivot back to Asia. At the same time it presents China much less as a threat than the previous white paper did:

Australia welcomes China's rise (...) The Government does not approach China as an adversary. Rather, its policy is aimed at encouraging China's peaceful rise (...) China's defence capabilities are growing and its military is modernising, as a natural and legitimate outcome of its economic growth (Defense 2013:11).

That can be read as the Gillard government trying to avoid aggravating China. If they depict China as a threat in the way the Rudd government did with its 2009 white paper, then that might confirm the Chinese leader's perception that Australia and others are in fact trying to contain China – playing into the hands of the more Hawkish parts of the Chinese leadership and bureaucracy⁵¹. In any case, the decision to paint a more positive picture of China seems unrelated to assessments of what China's economic response would be.

5.2.5 Little interest in lobbying

There seems to be little interest in the Australian business community to lobby the government over its national security policies. The one example I have found of something that resembled business interests seeking to influence the government's position came not from the mining industry but from a businessman with an interest in the Chinese market for construction machinery and mining equipment. His suggestions were quickly slapped down by the Foreign Minister. I suggest that the threat that China represents in all Australian minds is probably the explanation for this.

Kerry Stokes, media investor and chairman of a company which distributes Caterpillar equipment in China, criticized the government for accepting US troops on Australian soil. He said the decision to allow the US to base troops near Darwin undermined Australia's relationship with Beijing (Curran 2012). However, he was slapped down shortly after by Foreign Affairs Minister Dennis Richardson, saying that: 'our alliance with the United States is not up for sale (...) since when does any country worth its salt auction its alliance to the highest bidder?' (Quoted in Shanahan 2012). One respondent explained this further:

I don't think there's any government in Australia that would last very long if it took the advice of some business people in Australia who do say that. There are those who say that we ought to be

⁵¹ Argument made by Geoff Raby, Ambassador to China 2007-2010.

more considerate, or ought to be taking a more neutral stance between China and the United States because of our important trading relationship. First, I doubt that the voters would be very impressed if the government started talking or acting that way. Second, it wouldn't in fact increase our influence in China, it would probably reduce it. China has a pretty keen sense of where other people stand, and if they thought that we would bend on the basis of bigger contracts or punishment for not doing as China wanted, our leverage would reduce (Interview with Peter Rowe, First Assistant Secretary Peter Rowe at the North Asia Division of DFAT).

This goes back to the point made in 6.2.1. Several of the respondents said that China to a large degree accepted the alliance between the US and Australia, and that it was not a high priority for China in its diplomacy towards Australia. The Liberals Senator of WA said that: 'we've made it quite clear that we deal with China economically, and who we form alliances with is a separate issue. They seem to understand that'.

The politicians that were interviewed all expressed in one form or another worry about China building up its military capability. The Senator of the Nationals seemed particularly worried about this:

To be frank, China has got to build trust. They are a communist country, and they have a human rights history that's deplorable. India is nearly as big a country and it's a democracy. I am concerned that their population will keep growing and they get so powerful militarily that they will flex their muscles and try to take over the world. That would be a scary thought (Interview with John Williams, Senator of the Nationals).

Even though none of the other politicians regarded China as a direct threat to Australia militarily, they often questioned the motives of China's actions in for instance the South China Sea. Such concerns are reflected in the broader Australian population as well. In the 2010 Lowy Poll 69 percent of the respondents agreed to the assertion 'China's aim is to dominate Asia', while 63 percent disagreed with the assertion that 'Australia's interests would not be harmed if China gained more power and influence'. Australians are much more positive to increased US presence in the region. According to the 2012 Lowy Poll 74 percent of the respondents said that they were in favor of allowing up to 2500 US soldiers being based in Darwin (Hanson 2012:10).

5.2.6 Summary

In summary it seems like increased trade has not prevented Australia to any large degree in its defense choices. Australia has strengthened its alliance with the US over the decade, and also its security cooperation with Japan, South Korea and India. The Howard was especially willing to go

far for the continued well-being of the US-Australian alliance. The Rudd government's defense white paper, the threats that were made by Beijing in advance of its release and Canberra's choice to ignore those threats reveals that. Gillard decision to allow the stationing of 2500 US troops in Darwin further confirms this. Even so, the Australian government has throughout the period tried to avoid antagonizing China unnecessarily. Examples of this are the Howard government's positive public depiction of China, the Rudd government's withdrawal from the Quadrilateral Dialogue and to avoid sending ministers to Taiwan. However, these decisions seems not to have been the result of Chinese economic pressure, but rather a result of what the Australian government perceives to be in the nation's long term interest. Furthermore, there seems to be little willingness in the business community to lobby Canberra over its defense choices.

5.3 Differing Values: Australia's Criticism of Human Rights Abuses

In this section I assess whether Australia in the period has become less willing to criticize China over human rights abuses, and if so how and why this happens. First, I argue that it is a hard question to answer both because the Australian government in recent history has had an explicitly expressed pragmatic approach to human rights issues ('shouting about human rights doesn't deliver results'), and because the amount of criticism of China's human rights abuses from the top level has varied depending on who has held the position of Prime Minister⁵². Second, I show that Australian Prime Ministers have dodged the Dalai Lama on his recent visits, but argue that this is weighed up by criticism on other occasions. Third, I argue that business interests trying to lobby Canberra seem to hold some sway, but to a large degree are 'cancelled out' by other political actors.

5.3.1 The interests of the two parties

Here I will treat both sides' interests. While the interests of the Chinese government are fairly easy to define, those of the Australian government are not equally conspicuous. It seems like the Australian government sees it in its interest to influence the Chinese leadership's position on human rights issues. However, they have been pragmatic when it comes to the *means* of influence.

⁵² John Howard and Julia Gillard were more reluctant to speak about such issues in public; Kevin Rudd had no problem being frank about it.

China's willingness to use economic pressure

The Chinese one-party political system is of course devised in such a way that criticism of human rights abuses is also a criticism of the government. Chinese authorities regard its human rights practice as an internal affair, and outside interference is strongly rejected. The Chinese government has on several occasions shown that it is willing to use economic pressure in this area to silence criticism of what it regards as internal Chinese affairs. China's willingness to use economic pressure to counter criticism of its human rights policy was reflected in its response to the 2010 Nobel Peace Prize that was awarded to Chinese dissident Liu Xiabo. Before the announcement of the decision a senior Chinese official had privately warned Geir Lundestad, the head of the Norwegian Nobel Institute, that the award would have consequences for the trade relationship (Foster 2010). Norway was at this time in talks with the Chinese over a bilateral trade deal. After the announcement of the prize was made by Thorbjørn Jagland, the leader of the Nobel Peace Prize Committee, China cancelled a ministerial trade delegation to Norway and froze FTA talks (Glaser 2012). Sales of fresh Norwegian salmon to China fell drastically over the first eight months of 2011 (Skivenes 2011)⁵³. In addition China issued threats to foreign diplomats, telling them to stay away from the award ceremony or 'suffer the consequences' (Glaser 2012).

The autonomous region of Tibet (Tibet) is an especially sensitive issue for the Chinese authorities, as this is also a question of the integrity of China's borders. It is disputed in the international community whether China's incorporation of Tibet in 1951 was in accordance with international law. The area is also considered to be of vital importance to China because it holds vast amounts of natural resources, connects China to Central and South Asia, and because several important rivers have their origin here. As an exiled leader of the Tibetans the Dalai Lama is often accused by Chinese authorities of engaging in 'splittist' activities. Critique of the treatment of Tibetans and international leaders meetings with the Dalai Lama are seen as direct threats to the integrity of the Chinese nation state. But that is also the case for regions like Xinjiang that are populated by large groups of ethnic minorities – the Chinese leadership sees it in its interest to silence international criticism.

The Chinese administration frequently threatens, in a more or less direct manner, that meetings between its trading partners' officials and the Dalai Lama will be met with animosity and lead to a

⁵³ Yet aside from salmon exports, bilateral trade experienced no 'Nobel effect', according to Statistics Norway (Skivenes 2011).

subsequent deterioration in their trade relationships. This has been the case every time the Tibetan leader has visited Australia during the 2000s. In general it seems like the Chinese leadership is willing to bear the costs of acting on its threats as well; Fuchs and Klann (2010) examines 159 of China's trading partners and find that from 2002-2008, a reception by a country's political leader of the Dalai Lama resulted in an average 12.5 percent drop in exports to China for the following two years⁵⁴. After the two years there were no observed effects. This seems to have given results for the Chinese; in 2007 the Dalai Lama himself acknowledged that Government leaders had started to avoid him, so 'to not annoy Beijing' and risk economic gains (Lorenz 2007).

Australia's pragmatic approach

The Australian government has in recent history taken a pragmatic approach to international human rights issues in general. Foreign Minister from 1983 to 1988 Bill Hayden argued that moralizing publicly about human rights was counterproductive (Uren 2012:146). Foreign Minister from 1988-1996 Gareth Evans also argued that the government had to use those means that achieved the best results, and that public criticism was not always the best solution. In a keynote speech to Amnesty International Australia he stated that:

What is clear is that grandstanding is counterproductive. At best it draws attention to an issue but virtually no prospect of achieving improvements. At worst, it can lead to a hardening of attitudes and even to the execution of the victims (Evans 1989).

Australia was the first country to depart from the conventional modes of engagement and critique conducted by many other Western countries in relation to China. In 1997 the Howard Government abandoned the approach of criticizing China over human rights abuses on the floor of the UN General Assembly, instead initiating a bilateral human rights dialogue with China (McDowall 2009:18-19)⁵⁵. From this point differences concerning human rights have mainly been addressed in private negotiations⁵⁶. In addition there have been several DFAT-sponsored small-scale projects, for instance exchanges of senior judges.

⁵⁴ They did not find a similar effect in the period 1991-2002, something that indicates that China has only started trying to use trade for this purpose under President Hu Jintao.

⁵⁵ Uren (2009:148) and other commentators have pointed out that the Chinese were pleased with the announcement; and that it was quickly followed by a visit by then Vice Premier Zhu Rongji leading a strong Chinese business delegation.

⁵⁶ This approach has been adopted by many other Western countries, but Australia's human rights dialogue is the only one that has gone uninterrupted to this date.

As expected the Senators that were interviewed from the Labor Party and the Liberal Party supported such an approach; as did the senior bureaucrats and diplomats⁵⁷. Geoff Raby, who chaired the dialogue for several years before he took the position of Ambassador in 2007, explained it in the following way:

I don't think there is any value in having a big public argument with China over human rights. I think the hardline positions make it more difficult to move things forward internally in China. We have the bilateral human rights dialogue where China seeks advice on prisoners, and we have an opportunity to press for religious freedom and ethnic identity in Tibet and Xinjiang (...) I think over the years I was involved with [the dialogue] we really made progress. We went from shouting to each other and talking past each other, to the Chinese responding (...) I'm happy for NGOs, backbenchers and other members of parliament to [criticize]. There was a period a couple of years ago where the Chinese would get very upset with the Australian government, saying 'you have to stop these backbenchers in parliament criticizing us'. You can't, that is what democracy is all about. We would always robustly defend those democratic privileges and rights, but at the same time we want to help China make progress in this area. For the government to have influence it has to deal with it diplomatically as it does with other issues (Interview with Geoff Raby).

The argument is that criticism by the government can be counterproductive if it is the results that matter. Commentators often point out that this is very convenient way for Australia and other Western countries to avoid having to criticize China, that it is an equally convenient way for the Chinese leadership to prevent public discussion about their human rights record, and also that there are few tangible results from the dialogues (Uren 2012:149). The people mentioned took a different view; their assumption is that the Chinese leadership in fact wants to make progress on human rights issues; they want China to be viewed as a normal and respected country.

Many of the respondents also argued that the huge economic developments in China and its consequences for human wellbeing had to be taken into consideration when assessing the human rights situation. Raby said that:

A big part of it is to be clear that China has done an enormous amount to improve the human rights of a vast percentage of the worlds' population through economic development (...) The Chinese society is so much more open than it ever was, and people have advanced in so many ways (Interview with Geoff Raby).

Barack Obama's comments on China in his speech to the Australian Parliament in 2011, that 'prosperity without freedom is just another form of poverty' (Quoted in Lane 2011) did not

⁵⁷ The Australian Greens and the National Party were less impressed.

resonate well in all Australian ears. Former Prime Minister Paul Keating (1991-1996) for instance noted that the remark:

...placed a heavy discount on the success of the Chinese Communist Party in dragging its community from abject poverty (...) The seemingly perpetual invocation of this human rights mantra attributes no moral value to the scale and quality of the Chinese achievement (quoted in Earl 2012).

One respondent, the Senator of the Liberals, defended the Australian approach, and then expressed the possible positive long term implications in this area of engaging with the China economically.

The thing that I find terribly interesting is that there are many thousands of Chinese students in Australia. I've talked to some of them. They're exposed to an entirely different system in this country. Some of them say that they want to stay in Australia, and when you ask them why they say that 'China is not fair'. So in other words they're referring to the political system as not being fair compared to the Australian system. Of course they go around the rest of the world too. They take back an impression of what a democratic country can be like. You have to wonder about the long term implications of that in terms of the political structure of China and how it might be modified in time (Interview with Senator Alan Eggleston, Senator of the Liberals).

As mentioned in chapter 5, China is also the biggest single contributor to Australia's services 'exports'. There were about 160 000 Chinese students in Australia in 2011, and many more in other countries around the world, especially the US and the UK (Trounson 2013).

5.3.2 A complex approach

As reflected in the quote by Geoff Raby above, in the early 2000s China complained repeatedly to the Australian government about members of the Australian Parliament criticizing China over human rights issues. It seems that they over the years have abandoned such attempts and instead increased their focus on the government itself.

Avoiding the Dalai Lama

As shown in table x below Australian Prime Ministers have not met with the Dalai Lama on his recent tours in Australia. On his last three visits Kevin Rudd and Julia Gillard have (very conveniently) been out of the country. It seems that this issue has come to be resolved by delegating the task to one of the other ministers of the cabinet, something that is considered acceptable for the Chinese (ABC News 2011).

Table 8: Visits by Dalai Lama to Australia and receptions by Prime Ministers

Time period	Visits	Met with Prime Minister
1982-2007	5	4
2008-2013	3	0

In 2007 both Prime Minister John Howard and then opposition Labor Party leader Kevin Rudd met with His Holiness. But it is worth noting that initially they both stated that they would not meet with him. Only after accusations of ‘kowtowing to China’, they both said they would ‘check their diaries’ to see whether they had time (SMH 2007). Howard had not met with him on his last visit in 2004. The decision by both to meet with him may have been influenced by the fact that it was an election year: ‘Both sides of politics felt the need to demonstrate their human rights credentials’ (Zhang 2011:76). Another thing worth noticing is that when Howard did decide to receive the Dalai Lama in 2007 there was no trace of any Dalai Lama-effect on exports. The Chinese made threats in advance, and expressed outrage about it; but Australian merchandise exports almost doubled over the next two years from AU\$ 23 792 million in 2007 to AU\$ 42 526 million in 2009.

A ‘true friend’

During his 2007 visit, the Dalai Lama reportedly said that Australia should be a ‘true friend’ to China by pressing them on subjects such as human rights, democracy, press freedom and the rule of law (Maley and Hart 2007). Perhaps it was a mere coincident that this was exactly the approach that the new Prime Minister Kevin Rudd took as he resumed office in 2008. Rudd did not meet with the Dalai Lama as Prime minister, but on the other hand he had no problem speaking his mind about the situation in Tibet, Xinjiang or human rights abuses in China in general. Rudd believed that ‘The best way to prosecute our relationship with China is to be broad-based about it and not to pretend problems do not exist when they do’ (Shanahan 2008). Rudd’s approach to human rights was not the ‘typical’ approach of an Australian PM – but the years under which he was PM are especially interesting for the purpose of this study for exactly that reason.

On his first visit to China as the new Prime Minister, there were great expectations to what Kevin Rudd could achieve. He was fluent in Mandarin, had spent much of his youth in Beijing, and had worked at the Australian Embassy in Beijing for several years. However, his visit was overshadowed by recent crackdowns in Tibet, and international concerns about the human rights

situation in China in general in the context of the Beijing Olympics 2008. There were calls for Western political leaders to boycott Beijing Olympics (Zhang 2011:79). Before he met with the leadership, Rudd gave a speech to students at Peking University. In a thoughtful speech showing off the depth of his knowledge about China and the history of the University; he invoked the term 'zhengyou' to describe Australia's relationship with China. Zhengyou can roughly be translated to mean 'true friend' or 'principled friend'; a friend that can also point out the mistakes of his partner. In this spirit he made some of the strongest statements ever made by an Australian PM in China, pointing out that there were: 'significant human rights problem in Tibet. The current situation in Tibet is of concern to Australians'. He also advised Beijing to undertake dialogue with the Dalai Lama (Rudd 2008). The Chinese were not pleased with this, and the Chinese media focused instead on Rudd's support for the Beijing Olympics (SMH 2008).

Then, in his address to Parliament 4 June 2009 on the twentieth anniversary of the Tiananmen Square massacre, Rudd was the only Government leader in the world who took the opportunity to condemn it:

The Australian Parliament expressed its outrage at what had happened and condemned ongoing repression against those who had participated in it. Our views have not changed (...) Australia continues to raise our concerns about human rights with China. I have raised these matters in the past with Chinese leaders and will do so in the future (Quoted in Uren 2012:147).

The Chinese government found the Rudd government's high attention to human rights issues unsettling. In a meeting few days later President Hu Jintao told Rudd that 'the Tibet issue is entirely China's domestic affair' (as quoted in Zhang 2011:79). Chinese authorities also expressed disapproval through other diplomatic channels, but they did not take things further. In Australia however, Rudd was widely viewed as having done the right thing (Ibid).

5.3.3 Uighur riots, ETIM and a visit by Rebiya Kadeer

A month later, in July 2009, there was a clash between Uighur people and Han Chinese in Ürümqi, a town of one million people in the north-west of China. A large majority of the 200 dead and thousands injured were Han-Chinese (Uren 2012:139). Ürümqi is the main city of the Xinjiang in the northwest of China. Uighurs accounts for about half of the province's 20 million population, but there are also a range of other ethnic minorities as well as Han-Chinese living there (Buckley 2009).

The riots, and the situation of the Uighur's in Xinjiang would soon become another though issue to deal with in the Sino-Australian relationship. Commenting on the riots, Rudd first urged both sides to the conflict to exercise restraint. However, he went on, saying that: '*There are continuing human rights problems in China. I've never shied away from that fact. That is the reality*' (quoted in Uren 2012:140). The Chinese Foreign Ministry was outraged that Rudd presented the murder of Han Chinese by the Uighur minority as a human rights problem, and soon summoned Ambassador Geoff Raby for a verbal overhaul (Ibid).

Chinese authorities had themselves portrayed the riots as terrorist attacks. While the US had stepped up its 'war on terror' during the start of the decade, China had equally sought international support for its campaign against the East Turkestan Independence Movement (ETIM). ETIM's goal is to bring independence and Islamic rule to Xinjiang, and Chinese authorities have blamed them for a range of terrorist attacks in China. The World Uighur Congress and its leader, Rebiya Kadeer, have been presented by Chinese authorities as the political leadership of the ETIM. After the riots in Ürümqi the official Chinese position was that these riots and other problems in the region were being 'masterminded' by the World Uighur Congress led by Rebiya Kadeer – a business woman living in the US (Buckley 2009).

The week after the Uighur riots the Melbourne International Film Festival program was released, and one of the films on the program was a documentary about Kadeer titled *The 10 Conditions of Love*. In addition Kadeer had been invited to attend the festival as a guest. The director of the festival shortly thereafter received an angry phone call from the Chinese Consulate in Melbourne demanding that the film was withdrawn. Furthermore three Chinese films were withdrawn from the festival in protest, and computer hackers also attacked and brought down the festival's webpage. These attempts were counterproductive, as the matter now quickly became one of interest for the Australian national media. (Uren 2012:142-143). Chinese officials 'demanded that [the Australian government] immediately correct its wrongdoings and do not allow Kadeer to visit Australia' (Uren 2012:143). Canberra was unmoved by this, and Kadeer was granted a short term-visa.

In addition Kadeer was assigned an even greater role, as now she would not only attend the festival but also make an address to present the Uighur case. Following her speech in Melbourne, the Chinese embassy in Canberra released a statement denouncing the decision to allow her to come:

At a time when the Chinese public are mourning the innocent victims from different ethnic groups in the highly violent crimes in Ürümqi, the person who is responsible for the crimes is allowed to visit Australia and engage in anti-China separatist activities (as quoted in MacBean 2009).

In China the state-owned media boiled over as a result of Kadeer's visit. China Daily (a mouthpiece for the central government) for instance wrote in its editorial that:

Australia has made itself the champion leader of an anti-China chorus after the July 5 riots in Urumqi, in which nearly 200 innocent Chinese men, women and children were slaughtered by rioters. (...) Canberra chose to side with a terrorist and severely hurt China's national interests (China Daily, 2009).

Other news outlets went further, demanding trade sanctions against Australia (Garnaut 2010a). Subsequently, China's Vice minister of Foreign Affairs He Yafei cancelled a planned visit to the Pacific Islands Forum in Cairns. But nor in this case did the Chinese did not take things further. To the contrary, what is quite revealing with regards to the Chinese response is that on the same day that Yafei cancelled his visit, Australia and China signed a A\$50 billion LNG deal in Beijing – the largest ever in the bilateral trade history (Zhang 2011:82; Hartcher 2009).

Perhaps regarding a meeting with the Dalai Lama as a waste of diplomatic capital, Rudd seems to instead to have used this on speaking his mind about China's human rights situation when the opportunity arose in more informal contexts. Rudd's successor, Julia Gillard, has not been equally outspoken about human rights abuses in China. She has raised concerns in private talks with the Chinese leadership, including on her first trip to China as Prime Minister, but has given the Chinese fewer surprises than Rudd (Uren 2012:151-152).

Wesley asks an interesting question: 'if another Tianman Square massacre happened tomorrow, how many countries in the region, or for that matter the world, would break off their trade ties with China?' (Wesley 2012:202). In relation to Australia this hypothetical question is easy to answer. Economic ties with China have reached a point where it is impossible for the Australian government to break off trade with China without huge cost.

5.3.4 Successful and unsuccessful attempts at lobbying

Human rights issues seem to be the one area where lobbying from business interests has had some effect. However, these are to a large degree balanced off by counterforces.

The businesses and states that are most heavily involved in exports to China, this picture can look a bit different. In the interview with Resources Minister of WA, he said that:

It is quite possible that decisions being made in Canberra in relation to broader international political issues could affect the trade between Western Australia and China. And we would hope that the Government in Canberra recognizes that fact when they engage with the Chinese government (...). One example would be the Dalai Lama which visits us from time to time, and whether the Prime Minister meets with him or not (...). The Chinese is not backward in using their economic might to put pressure on governments in respect to those sorts of things. It is possible for those political issues to interfere with the trade relationship (interview with Norman Moore, Minister for Mines and Petroleum, WA).

He added that this was something they did not in any way press the government on. But even so the comment reflects the fact that the Minister represents a state that accounts for 70 per cent of the exports to China. Premier of WA Colin Barnett also publicly opposed the decision to grant a visa to Kadeer, quoting the already negative bilateral climate as the reason for his position.

I think it was silly, I just think at a sensitive time it was silly. I don't make any judgment about Rebiya Kadeer, but that is how incensed the Chinese were (...). I wouldn't have had Rebiya Kadeer coming, I don't think we need to inflame the relationship at a sensitive time (quoted in Cai and Hutchens 2012).

Especially with regards to the Dalai Lama and other highly sensitive issues it seems like business interests weigh heavy. However, Canberra cannot avoid criticizing China over such issues: this leaves it open to criticism of 'kowtowing to China' at home from the opposition, the Greens (and to some extent the Nationals), but also from NGOs, elements within the two biggest parties themselves and the general population. The Lowy Poll has been tracking attitudes on the government's handling of this issue since 2008: In 2008 62 per cent of Australians answered that Australia was not doing enough to pressure China to improve human rights. In 2010 66 per cent answered the same, while in 2011 this number fell to 58 per cent (Hanson 2008; 2010; 2011).

In relation to the visa granted to Rebiya Kadeer for instance, Foreign Affairs Minister Stephen Smith assured the Australian Parliament that the Chinese were 'most unhappy' with the decision, before firing off a comment that was surely aimed at the domestic audience: 'I vaguely remember the Leader of the Opposition saying to the Government some time ago that we should stand up to China (...). We did on the Rebiya Kadeer issue' (quoted in Hartcher 2009).

In an interview Economic Advisor to the Greens John Hawkins summed up what seems to be at work:

The Government tries to balance off some NGOs within Australia and the left wing within the Labor party who would like a more critical tone on the one side, and business interests on the other. There have been occasions where Kevin Rudd for instance has given pretty strong statements on human rights. Then business groups will get upset, and the government will backtrack and make a much milder statement. Then the left within the Labor party, NGOs, academics and other people will say 'you're being completely wimpy about this issue' and then the government has to swing back the other way. They're trying to find a balance depending on competing pressures on them.

It should be noted that Hawkins is modest. Clearly the Greens should also be included in the group who serve as a 'correction' to the government in these instances. The Greens have especially played a key role after the 2010 election, which resulted in a 'hung parliament'. The Labor Party has since had to rely on their support to stay in government.

5.3.5 Summary:

It is hard to assess whether the trade relationship has meant anything for Australia's approach to human rights. As I have shown China's ability to punish Australia economically over their criticism of human rights in the period seems to have been non-existing. While it has been established elsewhere that meeting with the Dalai Lama on average means a 12.5 per cent drop in exports to China over the two following years, the last visit by the Dalai Lama to Australia in 2007 was followed by a doubling of exports over the next two years. Also, despite other controversies China has had no other options but to take Australia's iron ore and other mineral and energy products. The fact that the government has still tried to accommodate China on some issues seems to indicate that they are worried about future economic opportunities with China, and the pressure from some business-people and state politicians who do not want to lose future contracts and investment opportunities. As I have shown this is particularly so in WA. However, the public and NGOs to a large degree seem to counterbalance these business interests.

5.4 Implications of economic interdependence in the 2000s

It has been shown in the three preceding subchapters that the Chinese government has been largely unable to move Australia on any issues. In line with the model Australia has not to any significant degree altered its trade, investment, or defense policies. In instances where it seems

like Australia has accommodated Chinese preferences it seems like this has not been done because of Chinese economic pressure, but rather because it is conceived to be in the national interest of Australia. The human rights issue might be an exception to this, but it is hard to conclude given several governments' expressed pragmatic approach on the issue.

In this part I will draw out the main points of the last three sections, and discuss these findings while also emphasizing the views of the respondents on these issues. By drawing on the views of the respondents I will substantiate the interpretations made in the analysis. The section has three parts. In the first part I discuss the two first mechanisms that have been suggested in the theory, namely economic pressure I and economic pressure II. I will start with the most serious kind of economic pressure, arguing that it would be extremely costly for China to apply such economic pressure, and then assess the weaker form of economic pressure. In the second part I discuss the third mechanism that was suggested in the theory, namely vested interests, arguing that there seems to be little interest in lobbying the government on issues related to China. In the third part I outline the possibility that the two parties 'learn' from their past conflicts, and to a larger degree seek to avoid them by extending the high-level contact between them.

5.4.1 Ability of the two to use economic pressure

In this section I will assess the ability if the two parties to use economic pressure. First, I will assess the diplomatic value to Australia of supplying China with a range of key commodities, and argue that it is not a basis for Australia to use economic pressure. Second, I will show why China's ability to use economic pressure in the period has been very limited, and why even economic pressure involving future business opportunities can have a considerable cost to China. I substantiate the argument by drawing on arguments provided by several of the respondents.

China's limited ability to use economic pressure

First off, though Australia supplies China with a range of resources that are of critical importance to the latter's domestic economy, Canberra cannot use this as a means of economic pressure against Beijing and has not done so in the period. If Australia as one of the most important suppliers to China of these commodities would start making demands from Beijing, they would quickly see their status as a reliable supplier disappear. That this was how the Australian government thought about their ability to exert economic pressure on China was fairly clear from the interviews with senior government officials and former diplomats. Furthermore Australia's status as a liberal economy and a middle power gives it an interest in a rules-based regime. Even

so Canberra can, and has, in certain instances reminded China that they too have considerable economic transactions at stake.

The interesting thing is that Beijing seems unable to exert any significant economic pressure of the first kind on Canberra. Reilly (2012a: 394) notes that China has been ‘remarkably reluctant to impose high costs’ on Australia. Iron ore imports from Australia has not once been held hostage to Chinese demands in the period despite the frictions and although there has not lacked threats of doing so. This is surprising, especially in 2009, when the relationship seemed to be deteriorating in all the issue areas that has been under study at once; with Chinalco’s failed acquisition of a larger share in Rio Tinto, the disputes over pricing of iron ore reaching a highpoint with the Stern Hu affair, Rebiya Kadeer’s visit to the Melbourne International Film Festival, and the threats that were made over the Defense white paper.

In line with this the senior government officials and former diplomats that were interviewed for this thesis considered Beijing’s ability to put pressure on Canberra by economic means as limited at best. When asked whether China could hold some commodities hostage in attempts to influence Australia’s foreign policy, Geoff Raby for instance said that:

I reject that argument, largely because they would have a hard time finding alternatives to key Australian commodities. It would be quite silly short term behavior (Interview with Geoff Raby).

The short-sightedness of any such threat was also pointed out by Neil Roberts, Resource adviser to the Minister of Resources, Energy and Tourism:

They can’t do it in relation to for instance LNG. Everybody knows you can’t stop the ships. Once you stop it creates all kinds of problems for everybody in the chain. It’s really expensive for everybody if you stop. In iron ore in current world markets, if you want to punish Australia, Vale would be happy to fill the gap for a while, but how long could they do it? It would be very expensive, and it would force up the price of iron ore, ironically (...) what’s China’s interest in doing that? (Interview with Neil Roberts).

The answer to his rhetorical question regarding iron ore is that it is probably the last thing that the Chinese government would want, as shown in 6.1.

Richard Rigby, who was responsible for analysis of north and south Asia at the Office of National Assessments (ONA) from 2001-2008⁵⁸, agreed with this sentiment, but he also

⁵⁸ ONA analyses international political, strategic and economic developments for the Prime Minister and senior ministers in the National Security Committee of Cabinet.

emphasized that the Australian government is aware that in terms of *future business* China has other options.

The government is certainly aware of the fact that both India and Brazil offer alternatives to the Chinese. So, we are not purely in a seller's market. This is one of the arguments which are used against people who tell the government that we need to be tougher on Chinese investment. The government can say: 'If we're tough in the ways you want us to be, we might find that they'll go to India or Brazil instead'. Fortunately, Australia has the benefit both in terms of proximity and quality (...) but the fact is that the government is very aware that there are alternatives. We haven't got the Chinese by the short hairs. However, they couldn't entirely switch to Brazil and India. *That means they can't really use that to threaten us, but neither can we use what we have to threaten them* [Emphasis added] (Interview with Richard Rigby).

In relation to the mechanisms that have been suggested, Rigby argues that China can't use the most serious form of economic pressure against Australia as the costs of doing so would simply be too high. When Rigby talks about future business he points out that China has other opportunities, and that the Australian government is likely to take this into account. This was pointed out by several others as well. Notice, however, that he also points to the advantages that Australia has besides the ability to supply a huge amount of the needed products. This was also pointed out by several other respondents. One respondent said that:

There are a number of reasons [why we are chosen], one because of the quality, but also because of political stability, reliability and established reputation. It's fine to be importing from and investing in Africa, or Latin America. But they are much further away, and it costs more to ship. Certainly places in South America can match Australia in quality. But it's not as efficient to ship. *We have all these advantages, so no matter what the state of the political relationship, it will still be something that China is going to take into account* [Emphasis added] (Interview with Peter Rowe, First Assistant Secretary of the North Asia Division in DFAT).

Australia has a range of advantages that make it both *more reliable* than many of the alternative sources of supply for some raw materials and *cheaper* than the alternative sources of supply for other raw materials. While LNG for instance falls in the first category, iron ore falls in the latter category. Even when China considers whether or not to use economic pressure involving future business opportunities these factors have to be considered. Rowe also added that 'punishing us by upping your reliance on someone else doesn't make much sense either'.

Furthermore, the historical context is especially important in relation to China, who long was nearly self-sufficient in most raw materials. This was pointed out by a respondent:

In Australia we see the resources trade as a purely commercial activity; the Chinese see it as of strategic importance. Since the mid- 1990s there has been a series of tipping points across a range of commodities and energy, where China has gone from being self-sufficient in raw materials and energy – and it has been for thousand years or longer – to becoming utterly dependent on foreign supplies of those things. So that is, for the Chinese who think in terms of self-sufficiency, an issue of national security (Interview with Geoff Raby).

During the roughest years of bilateral relations it seemed to be largely business as usual. As has been shown exports to China accelerated rapidly in 2009, 2010 and 2011. The signing of a 50 billion dollar LNG contract on the same day as Vice minister of Foreign Affairs He Yafei cancelled a planned visit because of Rebiya Kadeer says something about China's priorities, and hence also the country's ability to use economic pressure in relation to Australia.

However, Rowe also made an interesting comment later on in the interview about something that was considered to be unique to China. According to him 'companies in China will slow cooperation if they feel that it is not a good relationship at the top. It just means that we need to continue to work hard at a closer relationship'. Rigby elaborated a bit further on this point:

If a Chinese company knows that there is a good relationship then they are more than happy to do business. Chinese companies tend to see themselves more as Chinese. BHP Billiton will talk about being Australian when it's here, but when it's overseas it is whatever it is as long as they can succeed commercially. For Chinese companies it's not a good idea to be seen working closely with people who are seen to be unfriendly with China. If the bilateral relationship is good, they'll talk about it in positive terms. But if the bilateral relationship is going through a bad period, companies are much more likely to be reluctant to do much, they'll drag their feet: 'why should we be working with them when they're anti-China' (Interview with Richard Rigby).

Because of this it seems like good bilateral relations is especially important for Australia in relation to China. The Minister of Mines and Energy of WA Norman Moore stressed the importance of good bilateral relations (the absence of pronounced conflicts between the two central governments) for good business relations. He also stressed China's willingness and ability to use economic pressure:

They are quite capable of taking action against a country on the basis of political issues. It's not out of the question that China could seek to 'punish' a country that sells some products that has a different political perspective from what they Chinese government has. Because the Chinese government basically runs the whole economy, they are able through government policy to make decisions about importation of products from different countries. They have a control over their economy in a way that is not replicable in Australia. We've seen it in the relationship with Japan –

that then is reflected in the work being undertaken by Chinese companies (Interview with Norman Moore).

China's willingness to sacrifice some economic gains to achieve other goals has of course not been lost on political leaders that deal directly with China. It is not all that clear that the situation of Japan and that of Australia is directly comparable. Japan is by no measure a small economy, and processing trade, where the parts are made in Japan and assembled in China, accounts for a large part of their trade. Japan might also have these goods assembled in Vietnam or other countries (Lee 2012). Even so, what is important here, and what has been fairly clear throughout this chapter, is that heavy Chinese state involvement in the economy means that there is some uncertainty with regards to whether or not their companies are political actors. Other politicians and bureaucrats had different views on this.

Beijing can exercise control and it's no question that if you were an entrepreneur in China, and Xi Jinping rings you up and says: 'look mate, I need a favor' – I think you might help him out. But (...) the capacity to do that comes from the fact that you don't do it unless you have to. (...) If you are in the center, and I think that the Chinese do see the center in an imperial way, the power from the center depends on you exercising it very carefully and prudent. The more you exercise it the weaker you actually look (interview with Neil Roberts).

These factors, the perceived willingness of a China to use economic pressure and the possibilities to do so offered by heavy state involvement in the economy, seems also to be important when threats of economic pressure are assessed by Australian leaders.

When disagreements between Australia and China have occurred, the Chinese have also been *equally* eager to patch up relations quickly. When the relationship was deteriorating on all the issue areas that have been under study in this thesis in 2009, 'it was the Chinese who decided to put a floor under that downward spiral by sending [at that time Vice Premier] Li Keqiang at very short notice to Australia to discuss these issues, discuss the relationship'⁵⁹. Keqiang was dispatched to Canberra in late 2009, where he held emergency meetings with Rudd. The result of the extensive meetings was a joint statement on the bilateral relationship (Raby 2013). The joint statement was a 'codification' of the relationship inspired by the Howard approach, emphasizing the areas where the two countries had common interests rather than focusing on their differences (DFAT 2009). Stephen Fitzgerald, Australia's first ambassador to China and later a central figure in shaping the relationship between the two countries, noticed the same thing: 'It was interesting that the big initiative to put things back on track came from the Chinese side' (quoted in Garnaut

⁵⁹ Interview with Geoff Raby, Ambassador to China in this period.

2010a). Indeed, it would not be in Beijing's interest to be on bad terms with the region's 'one stop shop for raw inputs' needed for its industrialization (Huang and Austin 2012:78).

This indicates that China is unwilling to use the second form of economic pressure – or at least that they want to avoid being placed in a situation where they have to use it – in both cases indicating that they deem the costs as too high. It also seems like the two countries' governments to a large degree have sought to decrease the chance of conflict by further extending the level of contact between their respective leaderships. This will be discussed further in 5.4.3.

5.4.2 Little interest in lobbying for Chinese interests

There is no doubt that the mining sector of Australia has increased its influence in Australian politics during the last decade, and that they have also become more willing to use their increased weight in domestic debates. A clear sign of their power was their intense campaign against the Rudd government, at the end contributing to the downfall of the Prime Minister himself.

Even so there seems generally to be less interest in the Australian business community at lobbying Canberra over issues related to China, and the political counterforces on the events that some have tried to do so are considerable. With regards to Australia's foreign investment regime there seemed to be no unified position between the firms. The only ones who have explicitly lobbied the Australian government for Chinese interests either had a particular interest in the outcome (Rio Tinto) or was paid handsomely for their effort (Hawker-Britton). Furthermore there was a strong and negative political reaction against China's growing influence in the resources sector that was , and particularly over Chinalco's attempt to buy a larger share in Rio Tinto. There was also a public outcry against China buying up Cubby Station, Australia's largest cotton-farm. Foreign ownership has of course been an issue that has evoked strong emotions 'since the earliest instances of international trade' (Kim 2007:167). History has also shown that the resistance to foreign ownership has tended to fluctuate, so it is not impossible that the government's position may also change over time.

In the case of Australia's defense policy, the only event that I could find that resembled lobbying came not from Australia's domestic mining industry but from a business-man with a considerable stake in the Chinese market for mining equipment. His comments were quickly struck down by the Foreign Minister. It seems that the many political differences between the two countries and their widely different system of government give the impression in Australian minds of China as a threat. The politicians that were interviewed all expressed some concern either with regards to

China's military build-up, or its activities in the South China Sea. The view of China as threatening was also reflected in the broader population.

None of the politicians that I spoke with had experienced direct attempts by business to change their minds about issues related to China, and they also expressed that such direct attempts to lobby the Members of Parliament was not realistic. Senator Ursula Stephens of the ALP said that: 'It is far more subtle shaping of our relationship with China'. Many of the former diplomats and senior government officials told the same story. Wesley seems to be at least partly right in saying that:

While the policy debates over investment and strategic policy is conducted among influential elites in Australia, there is no sign of willingness among any of the participants to explicitly lobby for Beijing's objectives in Canberra (Wesley 2012:207).

It seems that one exception to this rule is whether or not the Prime Minister receives the Dalai Lama. One of the respondents said the federal government should be cautious on highly sensitive issues like this because it could have an impact on WA's economy⁶⁰. This seems to be a view that is shared by at least some other politicians in WA – recall that Premier Colin Barnett was critical of the federal government's handling of the Rebiya Kadeer-issue. John Hawkins of the Australian Greens, the party that is most critical to China's human rights abuses, said that on human rights in general the government seemed to run back and forth to appease different interest groups. Former ambassador Geoff Raby took a different view of the same process:

NGOs are one of a number of voices that contribute to forming policy, but still policy by a view of what the national interest is. Which isn't necessarily the same as the NGO view minus the mining industry view adding on something else.

5.4.3 Exchanging Power?

In the last two sections, and in the three previous sub-chapters, the potential of each side to use economic pressure has been evaluated. As has been shown, when conflicts have come to a head, both sides have chosen to restrain themselves. This is probably because they both realize that escalating further would spell out huge economic consequences for them both. The implications of this will be discussed in the following.

⁶⁰ Interview with Norman Moore, Minister for Mines and Petroleum in Western Australia.

In the introduction to this thesis, Geoff Raby was quoted saying that in the relationship with China energy and mineral resources 'gives us a level of influence well beyond our size in terms of population or geo-strategic importance'. When asked in the interview to elaborate on how this was, he said:

When they survey the region, why would they want to put special effort into the relationship with Australia? I think the answer is because of the resources and the weight that gives us in China's geopolitical, strategic point of view (...) if you are the biggest and nearest supplier of so many raw materials, *they will put much more weight on that bilateral relationship than they would in other circumstances* (Interview with Geoff Raby).

Among the diplomats and Senior Government Officials that were interviewed there seemed to be much agreement on this. First Assistant Secretary of the North Asia Division in DFAT Peter Rowe said that: 'Our resources do give us an 'in' into China; it means that China will take Australia seriously'. Former China-diplomat Richard Rigby said that: 'If we didn't have that we wouldn't be regarded as very important at all. Because we do have that we are given greater importance'. Former China-diplomat and former Head of DFAT Stuart Harris elaborated on exactly how he thought that China's dependence on resources from Australia was an 'asset' for Australia diplomatically:

If you for instance are in a position of Ambassador, it undoubtedly will get you to be in the top dozen or so ambassadors who get in to see people. If the Ambassador rings up and says he wants an appointment with a senior person he's likely to get it easier due to our resources. It can at times be important in terms of influencing particular events or particular issues that have come up; it means we can make representation on particular issues.

However, some of them argued that it would be wrong to attribute this only to the significance of the resources trade. Both Rowe and Raby pointed to their alliance with the US as an equally important factor 'in China's strategic, geopolitical mindset'.

In any case China places much weight on maintaining good relations with Australia. The two parties recently announced a Sino-Australian 'Strategic Partnership', which involves annual face-to-face meetings between the Australia's and China's leaders, regular economic talks and deeper defense ties. Under the agreement, annual meetings will take place between the prime ministers of the governments (Julia Gillard and Li Keqiang), an arrangement that exists as a formal process between China and only three other countries. The only other countries enjoying such high-level access are Russia, Germany and Britain, while the US has even more extensive diplomatic communication. Also, the Chinese President Xi Jinping has a direct line to Australia's Prime

Minister (Jakobsen 2013). This is just the latest addition in a number of such initiatives. Prior to this China and Australia had established nearly 20 dialogue mechanisms at the vice-ministerial level or above (ACCIW & CICIR 2012:20). Sino-Australian relations go far back of course, and these dialogues were not established over night.

What is the reason why China puts ‘much more weight’ on the relationship, as these diplomats describe it? In a broader sense it seems like the keen interest of both sides for good relations and multiple levels of contact stems from a wish to limit the potential for conflict to the degree that this is possible. As highlighted in the past three subchapters the differences between these two countries leave a lot of potential for conflict, and there is also a lot of room for misunderstanding when either side does not explain fully what it is doing.

As has been shown they are both economically vulnerable; and to borrow a line from Hirschman the enormous gain from the trade to both parties means that they both have the power to inflict enormous damage on the counterpart: Australia exporting close to 30 percent of its total to China, China importing a range of key raw materials from Australia. As has also been shown there has been repeated conflict and threats of economic punishment, yet when these conflicts have come to a head both parties have for the most part chosen to avoid escalation. This is probably because they both start realizing that escalating further would spell out huge economic consequences for them both. In terms of the theoretical possibility that was outlined in 2.3.3, it is still too early the steps that have been outlined here are motivated by reducing such a risk, then the future ties between Australia and China

The importance of building trust in terms of understanding the counterpart’s intentions on the top levels of government has been pointed out by some analysts already (Jakobsen 2012), but in this light it becomes even more important.

6 Implications and conclusion

In this chapter I will draw out the main empirical findings and theoretical contributions of the thesis. I will discuss some limiting factors of the thesis, and then make some concluding remarks.

6.1 Empirical findings

In the introduction this thesis was placed in relation to the literature on dependence theory with a focus on the asymmetrical case, and on the Sino-Australian interdependence relationship in particular. I asked the question:

How has the balance or asymmetry in economic dependence between China and Australia affected each side's political leverage over its counterpart?

To answer this question, I built a theoretical framework based on dependency theory. I argued that three factors determines who is most dependent on whom in a bilateral economic relationship: (1) the total net gains which they receive from trade within the dyad, (2) whether the commodities traded are considered critical or non-critical and (3) the alternative markets and sources of supply that are available to both parties. Then I introduced an analytical distinction for determining how serious this is to each individual country; sensitivity dependence and vulnerability dependence. I introduced other factors that can influence and are influenced by the dependence relation. Lastly, I mapped out the different ways that this can be translated into political leverage – particularly through the mechanisms of economic pressure and lobbying interests. This theoretical framework was used as a basis for answering the research question.

Based on the three indicators, I showed that the economic interdependence relationship between Australia and China seems fairly balanced, thus clarifying the first part of the research question. I showed that both parties were economically vulnerable; the enormous gain from the trade to both parties means that they both have the power to inflict enormous damage on the counterpart: Australia exporting close to 30 percent of its total to China, China importing a range of key raw materials from Australia. It was shown that iron ore was of particular importance to both parties. For Australia exports of iron ore to China represented 16.7 percent of its total merchandise trade in 2011. For China this commodity was shown to be considered of particular importance to China because of the importance its steel industry. Furthermore about 40 percent of China's imports of iron ore during the whole period came from Australia.

Through the analytical distinction between sensitivity and vulnerability, I showed the nuances in each party's dependence. I showed that China was vulnerable to interruption of trade in international resource markets, especially in iron ore, and that its steel sector was sensitive to rising prices in the iron ore market. I showed that Australia's economy as a whole is sensitive to alterations in demand and falling prices, and vulnerable to an interruption of trade flows in iron ore. Making the distinction between vulnerability and sensitivity was important in assessing how the differences in dependency lay the ground for the political leverage of the two parties.

I then showed the political leverage of each party in four central conflict areas: I analyzed developments in four policy areas where there has been particularly much conflict: trade, investment, defense policies and human rights. This was done to assess each side's political leverage over its counterpart, and map out the causal mechanisms from interdependence to political leverage. I separated the two economic conflicts, from the conflicts based on political differences. It showed that Beijing has been largely unable to force Canberra to move on the issues. In line with the model Australia has not to any significant degree altered its trade, investment, defense or human rights policies. In instances where it seems like Australia has accommodated Chinese preferences it seems like this has not been done because of Chinese economic pressure to do so, but because it has been seen to be in the interest of Australia.

Lastly, I showed that economic pressure is a potential central causal mechanism leading from balanced interdependence to political 'stalemate'. As shown, when the conflicts have come to a head both parties have tried to avoid escalating further – and it did not come to the point where trade was held hostage for political concessions. Both parties have seemingly realized that escalating conflicts further would spell out huge economic consequences for them both. The Australian government is aware of the fact that other countries offer alternatives in terms of minerals to the Chinese, and Canberra do not dare issue economic threats against Beijing. That would quickly see its status as a reliable supplier disappear. However, Australia has a very large benefit in terms of proximity and quality to the Chinese market and Chinese authorities are also aware of this. It is not in Beijing's interest to be on bad terms with the region's 'one stop shop for raw inputs' needed for its industrialization. Each side's opportunity of using economic pressure thus seems to cancel out the other - meaning that neither side can credibly threaten the other.

It is also interesting that there is so little interest in the business community in lobbying Canberra over policies related to China. This seems to be explained partly by the many differences between the two countries, and the unease in the general public about China.

6.2 Theoretical Implications

First this thesis has shown that when assessing countries' two-way economic interdependence and its implications for who is the strongest party to the relationship, it is a minimum that one also looks at the kind of commodities that are traded. The proportion of the two countries' total trade with each other might be the only factor that determines who is most dependent on whom economically, but it is not necessarily so. In relation to China too much of the realist literature forget the Chinese part of the story when they assess China's Asian neighbors and Australia's dependence on China. In relation to South-East and East Asian states, China's economic leverage may be limited by the fact that close to two thirds of its trade with these states is processing trade. In the case of Australia, who supplies China with a range of raw materials that are of utmost importance to China's continued growth, it is definitely a factor. An assessment of the Sino-Australian dependence relationship should take into account the commodities that are traded, and by extension also the alternative markets and sources of supply of the two states. This point has been made several other places in the literature already. However, I have not seen any contribution that makes the whole case from taking into account the critical goods in the interdependence variable, to explaining the political 'stalemate' in the main policy areas of conflict.

Second this thesis has reconfirmed that the analytical distinction between sensitivity and vulnerability can be useful to interpret and understand the nature of each country's dependence. This has also been pointed out by several earlier theoretical contributions, but there still seems to be less interest in using this distinction in practice. Especially the vulnerability concept seems to be useful to understand how economic asymmetry can give the opportunity for a country to exercise influence on another. In the Sino-Australian case the relationship was fairly balanced – both sides were vulnerable – the interesting thing is that time and time again it was shown that both sides preferred to step back when the conflicts escalated. The vulnerability concept may be especially relevant for understanding China's relationship with Japan and other Asian states, as well as that with the US – on the surface at least these also seem fairly balanced. But even when one country is vulnerable and the other is not, there will not be a 1:1 relationship between the asymmetric interdependence and the political leverage that results from it. For a range of reasons, even when threats are credible they can still fail to produce the outcome wanted.

Third, focusing on causal mechanisms, this thesis stands in contrast to much of the realist literature on the topic, which focus strictly on whether or not Australia has accommodated

China, and not so much how or why this happens. By delving deeper into why Australia chooses to do one or the other, and how the government thinks about the economic dependence on China, the thesis makes a contribution by opening the black box that much of the literature keeps closed. In relation to the Sino-Australian case, it seems to describe a part of reality that the realist literature has not caught, and that is arguably more in line with the thinking of political decision makers on the ground. The mechanisms that have been used, economic pressure and vested interests, have both given interesting findings.

Lastly, this thesis has sought to show the continued relevance of asymmetric economic interdependence theory.

6.3 Concluding remarks

In the introduction to this thesis, I asked how the balance or asymmetry in economic interdependence between China and Australia affected each side's political leverage over its counterpart. In short, my conclusion is that the economic balance in dependence seems to have contributed to a balance in political leverage, where neither side can force its own interests on its counterpart. Further, the mechanism that connects the two seems to be the causal mechanism of economic pressure – that is, the pressure of mutually assured critical damage.

After several open conflicts, both parties have seemed to try to minimize conflicts through acting pre-cautious and defensively. As the relationship has evolved, the two seem to put a lot of work into avoiding conflict. Will they to a larger degree 'mind their own business', by seeking to prevent conflicts from erupting and minding the sensitive issues of the counterpart? Or if the large differences between them continue to create conflict in the future, will they realize the hazard that this poses to them economically and bargain rather than make threats? It is too early to conclude definitely on these questions.

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Appendix

Attachment 1: List of respondents.

Name	Title and key experience	Time/place
John Williams	- Senator, Nationals	February 6, Parliament House Canberra
Ursula Stephens	- Senator of the ALP, Chair of the Economics Committee	February 6, Parliament House Canberra
Alan Eggleston	- Senator of the Liberal Party, former Chair of the Economics Committee, Leader of the inquiry into Foreign Investment by state owned entities in 2009,	February 21, Senator's Office Perth
John Hawkins	- Economics adviser to the Greens, assistant to Australian Greens Leader Christine Milne	February 18, ANU Canberra
Peter Rowe	- First Assistant Secretary of the North Asia Division, Department of Foreign Affairs and Trade	February 13, Canberra
Geoff Raby	- Chinese Embassy's economics division 1986–1991 - Deputy Secretary at DFAT 2002–2006 - Australian Ambassador to China, 2007-2011 - Today also on the board of FMG	February 20, Hyatt Hotel Perth
Richard Rigby	- Worked in DFAT from 1975-2001; amongst others posted in Beijing twice - Assistant Director-General at the Office of National Assessments (ONA*) 2001-2008; responsible for North and South Asia - Executive Director of the ANU China Institute	February 14, ANU Canberra
Stuart Harris	- Former diplomat - Head of DFAT 1984–1988	February 27, ANU Canberra
Neil Roberts	- Held various positions in the Government of Western Australia in the period 2001-2006: Policy Advisor for Mineral Resources to the Minister of State Development of WA Chief of Staff, Department of State Development Resources adviser to the Premier of WA - Adviser to the Minister for Resources, Energy and Trade at the federal level 2008 to present	February 27, Parliament House Canberra
Carl Ungerer	- Adviser to the Foreign Affairs Minister - ASPI analyst, participated in report on resource diplomacy	February 27, Parliament House Canberra
Norman Moore	- Minister for Mines and Petroleum, Government of Western Australia	February 27, Phone interview
Jeoffrey Wilson	- Dr. at Murdoch University, Fellow of the Asia Research Centre	February 22, Murdoch University Perth
Peter Colley	- National Research Director of the Mining & Energy Division, Construction, Forestry, Mining & Energy Union	March 1. Sydney
Meeting with Jonathan Rollings, David Earl and Stewart Nixon	- Rollings: Foreign Investment Review Board, - Earl and Nixon: Foreign Investment and Trade Policy Division of the Treasury	February 18, Treasury building Canberra
John Ravenhill	- Head of School of Politics and International Relations, ANU	

*ONA assesses and analyses international political, strategic and economic developments for the Prime Minister and senior ministers in the National Security Committee of Cabinet.

Attachment 2: Interview Questions to Senators of Labor, Liberals, and Nationals, and the economic adviser to the Australian Greens.

Section 1: About the relationship to China

1. What do you see as the most important implications of increased trade with China?
2. Does increased trade in your opinion mean increased dependence, and who is dependent on whom?
3. Is this economic 'balance' reflected in the two parties leverage when discussing other matters?
4. To what degree is increasing Chinese military capabilities a threat to Australian national security?
5. Some have argued that deeper economic ties with China have been 'balanced' by deeper strategic ties with the US – what is your opinion?
6. The FTA with the US has increased exports of the US to Australia and decreased exports the other way around – is this an example of an economic deal mainly for strategic purposes?
7. Does the fact that Chinese military power is growing regionally have any impact on these matters?

Section 2: What separates China from other main trading partners?

8. How, in your opinion, does China differ from Australia's other main trading partners?
9. Do Chinese enterprises act like other TNCs or do they differ, and if they differ – how?
10. Is Chinese ownership of Australian mines a problem, and in that case why?
11. Why or why not should the Foreign Investment Review Board (FIRB) screen investments from China (Chinese State Owned Enterprises) closer than investments from other countries?
12. Should further regulations be put in place, are current regulations ok, or are they rather too strict?

Section 3: Domestic political implications of the increased trade

13. How important is the mining sector for Australia's economy?
14. Is the importance of the mining industry of Australia reflected in its political influence?
15. Has the mining industry become more or less influential during the last decade?
16. The mining sector no doubt profits from the relationship with China – are they in your opinion trying to influence the positions of the Members of Parliament in any way, and in that case on what issues?
17. About 70 per cent of Australia's exports to China stem from the state of Western Australia. Some Officials, among them current Premier of Western Australia Colin Barnett, have stated that China is more important to them than is Canberra, adding that. What do you make of such statements?