

CHAPTER 6

Framework for capturing opportunities and managing risks

KEY MESSAGES

Australia and China should aspire to a bilateral relationship of the high level and scope that they established during the foundational period of economic ties in the 1980s, when they agreed on a 'model relationship' for cooperation between countries with different political and social systems and at different stages of economic development. The enormous transformation to new economic models that Australia and China are currently undergoing calls for the elevation and direction of their partnership in a similar way.

There are significant untapped opportunities to increase two-way bilateral trade, investment, finance and cooperation on regional and global issues. Realising these opportunities will be important for the long-term economic performance and security of both countries.

There are three major types of risk in the bilateral relationship: commercial risks; macroeconomic risks; and system difference risks. Commercial and macroeconomic risks require the adoption of normal business strategies and policy capabilities to avoid or ameliorate their cost. System difference risks are structural and subject to change over time. They are more complex to mitigate, requiring political as well as business leadership in order to frame strategic arrangements for the conduct of the relationship.

The opportunities are best realised and the risks best mitigated through political leadership on both sides that mobilises bi-national work programs to advance priority interests and work through issues in the relationship. This provides impetus and a unifying vision that is key to commanding the attention and focusing the resources of official and private actors.

- Australia and China should upgrade their bilateral relationship from a 'Comprehensive Strategic Partnership' to a 'Comprehensive Strategic Partnership for Change'. This unique categorisation of the Australia–China relationship would signal bilateral commitment to staying ahead of the reform curve in implementing needed economic policy initiatives and strategies, and provide an exceptional opportunity for China to work with the smaller-scale yet more developed Australian economy as a testing ground for change.
- Australia and China should work over the coming years to develop their new partnership into a comprehensive bilateral Basic Treaty of Cooperation that embeds frequent high-level political dialogue; institutionalises official bilateral exchanges and technical cooperation programs between ministries and branches of the military; pools approaches between federal–state governments in Australia and central–provincial governments in China; and provides for the comprehensive setting of strategic bilateral objectives and forward work agendas every five years.
- The Comprehensive Strategic Partnership for Change should encourage investment in national centres of research excellence to support understanding of the forces that will shape the development of the economic relationship between Australia and China in its regional and global settings. That will ensure the relationship has the necessary intellectual underpinnings to thrive.

- Australia and China should establish a bi-national Australia–China (Ao–Zhong) Commission to dramatically boost the level and range of scientific, official, business and community exchanges between the two countries and drive the accumulation of human capital and networks needed to take Australia–China economic relations to the next level. It will promote an ambitious bilateral program of ‘literacy’ capacity building, multi-level scholarly exchange, bureaucratic network building, political interactions and sustained high-level business dialogue, and develop a forward work agenda for improving economic policymaking coordination.

This is a time of great change in China, Australia, the region and the world. There are enormous opportunities still to be grasped on both sides. This chapter will review key opportunities in the relationship, identify the major risks in realising those opportunities and propose a framework for managing these risks and getting the most out of the relationship.

As both countries adapt to China’s transition to a new economic model, this Report proposes that they upgrade their relationship from a Comprehensive Strategic Partnership to a new and unique level as a ‘Comprehensive Strategic Partnership for Change’. This would signal the determination of both countries to focus the relationship on achieving their goals for economic and social change. The task of such a partnership would be to energise and deepen the current bilateral institutional arrangements, build trust around common economic and political interests, manage the uncertainties of change, and develop the close commercial and business engagement needed as the structure of the economic relationship shifts towards services and consumers (see Chapter 1).

Opportunities

The opportunities in the Australia–China relationship derive from the growth of China’s wealth and its importance in the world economy, the strongly complementary relationship of Australia to China’s trade and industrial transformation because of Australia’s competitiveness in international resource and energy markets, Australia’s ability to meet many of China’s new demands, their relative geographic proximity and their close political engagement since China’s reform and opening began in the late 1970s.

Foundations

The foundation of the interaction between Australia and China is their deeply complementary economic partnership, which continues as the bridgehead of bilateral engagement. The natural complementarity between their economies has deepened the relationship since Australia committed to engagement in China’s reform and opening process. Australia’s abundant, stable and low-cost supplies of resources are critical to China’s continuing growth, investment and urbanisation. China’s demand for these resources has sustained strong trade and economic growth in Australia — direct trade with China is calculated by the Australia–China Business Council (ACBC 2015) to have contributed over 5.5 per cent of Australian GDP between 1995 and 2011. This is the biggest contribution of any country and twice as large as that of agriculture, forestry and fishing.

The foundations of the bilateral relationship also encompass the assets that have been built through the success of the relationship, symbolised in the present Comprehensive Strategic Partnership.

New economic model

While the resource trade remains a central element in the bilateral trade relationship, the end of the commodities boom and the emerging transformation of China's economy from an investment-export model to consumption and services-led growth opens new opportunities in the trade relationship. The opportunities for growth in the relationship now lie in energy, agriculture, high-value manufactures and especially in services. China will continue to export manufactures and be a strong net source of migration to Australia while capital exports will grow and diversify. The upgrading of China's industrial economy will push growth in its trade with Australia into new markets for machinery, high value-added manufactures and equipment, and capital into all sectors of the Australian economy.

Major flows of Chinese tourists, students, investors and migrants into Australia and more Australians students, tourists and investors spending time in China will equip more Australians and Chinese with interests and capabilities in improving business, cultural and political relations.

Investment and financial opening

Two-way flows on investment, particularly FDI, will be critical to new trade and commercial growth between the two countries. Chinese investment can help Australia to address its significant infrastructure gap, while Australian investment is injecting developed-market expertise into emerging sectors of the Chinese economy. FDI in each other's economies will endow businesspeople in both Australia and China with a long-term commitment to managing not only commercial but also public issues that have to be navigated in the relationship as it changes to one that involves closer engagement in business in each country.

The financial integration that will flow from China's ongoing process of financial market and capital account liberalisation is an area of particular opportunity and importance. Liberalisation will release massive volumes of Chinese savings searching for higher returns, creating a major investment pool as Australia seeks to upgrade its infrastructure, internationalise its supply chains and invest in innovation. Reducing barriers to trade in financial services is part of the step-by-step process involved in these reforms and Australia can work with China in pioneering change in these markets. Liberal financial markets, fully convertible currencies, and open current and capital accounts will diversify and stabilise the interaction between Chinese and international capital markets, but this goal will take time to achieve. Meanwhile, steady experimentation and sharing of policy experience can help along the way.

The Comprehensive Strategic Partnership for Change would encourage and support new commercial partnerships between Australia and China that make use of both countries' innovation agendas to harness technology to improve bilateral trade and commercial ties.

Partnerships make commercial sense in building business only where local, up-close engagement delivers returns. Getting close to the customer requires knowing the customer well. Partnerships are an effective vehicle for bringing suppliers and customers in China or Australia closer together, expanding markets, improving efficiency and delivering competitive products and service.

Common regional and global assets

Australia and China have a strong interest in a peaceful and prosperous regional and international system. Crucial parts of this order are well established in the post-Bretton Woods institutions and the United Nations framework, but there are gaps and the order needs to evolve to meet new challenges. Some of the priorities are dealt with in Chapters 7 and 8. Here the focus is on the principles and approaches that will help create the consensus that is needed to make progress where significant deficiencies remain.

Australia and China have the chance to build bilateral partnerships that are ahead of the economic reform curve in both countries and that set the benchmarks for broader regional and global economic collaboration (Box 6.1). China is facing a decade of challenging yet crucial domestic and international economic policy reforms, and Australia provides a proving ground for China to test the pathways through many of these reforms on the way to higher-income advanced economy status. Australian and Chinese policymakers can use their partnership to help push through domestic economic reforms and to strengthen the structure of regional economic architecture.

China's standing in the Australian and Asia Pacific economies is bound to rise if it succeeds with its continued program of economic and social reform. In the international arena, China is becoming an increasingly global power and naturally seeks to secure commensurate representation in global governance and to play a more important role in international affairs. Australia can play a constructive role in supporting these developments.

The economic changes underway will also impact on political relations. Both countries share interests in developing arrangements that strengthen regional and global political security.

BOX 6.1: AUSTRALIA, CHINA AND REGIONAL INFRASTRUCTURE INVESTMENT

The Northern Australian economy is heavily dependent on the mining sector and is now seeking economic diversification. While resources, including energy, will continue to dominate Northern Australian industry, the Australian government is anticipating that growth sectors for its future include: food and agribusiness; tourism and hospitality; international education; and healthcare, medical research and aged care. Northern Australia has a sizeable deficit in the infrastructure that is needed to realise this growth potential. The Australian government has set up an A\$5 billion concessional loan mechanism, the Northern Australia Infrastructure Facility (NAIF). Businesses from any country are potentially able to access these loans, but it is clear that still much more capital will be needed to develop the region (Government of Australia 2015b).

The North is already very open to foreign investment. Much of the capital used to finance the resource sector is already foreign-owned. There is a strong link between foreign investment and local wages and community development. The North's sparse population also makes finding the space for large developments easier than in many other areas of Australia. Most importantly, Australia simply does not have the domestic savings necessary to build and upgrade ports, pipelines, logistics networks and transportation facilities. Australia has persistently run large current account deficits, averaging above 3 per cent of GDP between 1960 and 2015. Any overall expansion in investment — whether in the North or anywhere else in the country — will likely come from foreign savings.

There are other reasons why Chinese investment in the North may be favourable to both China and Australia. China has developed a world-class infrastructure industry, while the North needs large-scale infrastructure development. Northern infrastructure can service and integrate with transport and communication networks elsewhere in the region, potentially achieving economies of scale and scope. Australia's demand for infrastructure investment in the North and across the country matches China's appetite for both infrastructure investment and for its firms to be involved in large-scale infrastructure projects. Investment in Northern Australia will facilitate regional trade, increasing Australia's regional integration with Southeast Asia and providing the region with better access to its land, resources and knowledge. With capacity to deliver abroad, China's strategy is to invest outwards to address the US\$8 trillion regional infrastructure gap via initiatives such as OBOR.

OBOR consists of the New Silk Road Economic Belt and the 21st Century Maritime Silk Road. The Belt and Road are envisioned as extensive networks of Chinese commerce, investment and infrastructure projects extending along the country's key strategic trade routes west and south. China has committed US\$40 billion to a Silk Road Fund and created the multinational US\$100 billion AIIB, which could help finance OBOR projects. In his speech to a joint sitting of the Australian parliament on 17 November 2014, Chinese President Xi Jinping declared that Oceania was a 'natural extension' of the Maritime Silk Road, and he invited Australia to participate in OBOR (Thomas 2015).

The wheels are already in motion. The 2015 round of the Australia–China Strategic Economic Dialogue focused on regional infrastructure investment, and formed working groups to explore opportunities in Northern Australia and the region, including the potential role of the NAIF and AIIB (Treasurer of Australia 2015c). Representatives from major Chinese investors participated in the Northern Australia Investment Forum that was hosted by the then Minister for Trade and Investment Andrew Robb in Darwin in November 2015. Australia should seek to support the AIIB funding projects that are a part of OBOR, such as by using the AIIB to source capital for world class infrastructure.

OBOR and the AIIB also have the potential to facilitate partnerships between Australia and China on infrastructure projects in third countries. For example, a Chinese state-owned asset management company could provide the capital, a Chinese construction company could provide the materials and labour, and an Australian consultancy could provide the project planning, financial forecasting, risk and talent management, and contracting out specialised technical inputs for a major infrastructure facility project in a country like Myanmar or Indonesia (Lumsden et al 2015). A joint approach to regional infrastructure can be further enhanced through the Global Infrastructure Hub in Sydney.

Under the Comprehensive Strategic Partnership for Change, the Australian and Chinese governments should upgrade their cooperation on OBOR through appointing a dedicated high-level joint working group to deepen and extend the work already being undertaken by the SEC Investment Working Group to explore the practicalities of how the two countries can better work together to enhance domestic and regional infrastructure.

Risks

In all big economic and political relationships, such as that between Australia and China, there are uncertainties and unpredictable occurrences that create risks that have to be managed. In partnerships that are relatively new and growing rapidly, especially where the scale and activities of one partner changes rapidly, as has been the case with China, associated uncertainties and heightened chances of unpredictable events exaggerate perceptions of risk. Between countries that have different histories and political cultures, system differences add another dimension to risk in managing relationships. Learning and experience will reduce these risks. But private and public effort is important to the understanding of the risks born of change and the differences that will remain — and finding ways to work around them to achieve economically and socially productive outcomes from exchange. This Report sets out a taxonomy of risks that confront the Australia–China relationship: commercial risks, macroeconomic risks, and system difference risks. The goal of the Comprehensive Strategic Partnership for Change should be to forge a bilateral relationship that goes beyond that which is basic between two countries and that can withstand and thrive around unexpected changes in either country.

Commercial risks

There are firm- and industry-level commercial risks across all markets. These include issues of due diligence, market access, regulatory enforcement and local operations in other countries that impact upon specific actors in the bilateral economic relationship.

Commercial risks are a normal part of the decision calculus of a company seeking to expand its trade, investment or operations in another country. Companies that assume these risks in search of higher returns need to have a strong grasp of local markets, regulations and business practices. Still, such risks are amplified in new markets where companies have no prior experience and little background. This has been the case for some firms in Australia and China who, attracted by the excitement of new possibilities for profitable investment in the other country, were drawn into ventures that underestimated or otherwise miscalculated commercial risks. While the first-mover advantage is real, it needs to be adequately balanced by normal business considerations.

It is not the role of the Australian or Chinese governments to conduct due diligence on behalf of companies and cover their failures. But both leaderships have an important messaging role to play: in fostering bilateral business sentiment that is realistic about opportunities, while encouraging investment projects where there are the capabilities and relationships to forge sustainable commercial partnerships; in upgrading market awareness (through Austrade in Australia and MOFCOM in China); and in building competencies for both Australian and Chinese firms (Box 6.2).

BOX 6.2: EXPERIENCE WITH COMMERCIAL RISKS

Two early Australian movers into the enormous and potentially lucrative Chinese market were its major brewing companies, Lion Nathan (now Lion) and Foster's (Gettler 2004; Slocum et al 2006; Chung 2011). Lion Nathan spent over A\$350 million building breweries and buying into joint ventures in the Chinese market from the mid-1990s, but eventually sold off its businesses for only A\$220 million in 2004. Lion's strategy in China was similar to its approach in Australia, which was to invest heavily in volume-building and competitive pricing. However, confronted by high distribution costs and intense competition from local brands in the low-end of the market, it had to withdraw. For a foreign company in China's fragmented and still maturing beer market, other areas such as branding, marketing and the logistics of distribution should have been more important considerations. These areas required sophisticated market engagement and high-level knowledge of local operations that comprehended Chinese market realities and employed bicultural human resources. Foster's Group limped out of China in 2006 after experiencing similar challenges. The challenges faced by Lion Nathan and Foster's show the necessity of advanced market and regulatory knowledge, sustained on-the-ground engagement and the prudent assessment of logistical risks.

The Sino Iron project in Western Australia is 'famous in China as the single most disastrous outbound investment deal in Chinese history' (Garnaut 2014; Australian Centre on China in the World 2015). In 2006, Chinese state-owned holding company CITIC Pacific signed a A\$5 billion 25-year deal with Australian miner Mineralogy to mine magnetite iron ore in Western Australia's Pilbara region — the largest-ever Chinese investment in Australia. When CITIC bought into the Sino Iron project it lacked experience in both the iron ore industry and in the Australian market, but was attracted by getting a slice of the lucrative Australian iron ore trade. The Sino Iron project suffered massive cost blowouts from a range of predictable risks — transportation bottlenecks, weather events, rising labour and capital costs, and a strengthening Australian dollar. A highly publicised dispute between Mineralogy's owner Clive Palmer and CITIC over royalty payments, among other issues, exacerbated the project's commercial problems.

But at the heart of Sino Iron's problems was the lack of a clear assessment of local conditions and regulatory processes (CITIC 2012; Duffy 2012). Differences in Chinese and Australian commissioning requirements, such as the certification of safety documents by licensed engineers, were not adequately considered. CITIC's budget and timeframe were stretched further by a shortage of the qualified electricians required by Australian regulations to commission control systems. Personnel movement posed problems as the processing of hundreds of equipment service providers' visas far exceeded the expected timeframe. A planned investment of A\$3.46 billion ballooned to expenditures of over A\$10 billion. When magnetite exports commenced in December 2013, the project was four years behind schedule. This delay cost CITIC dearly, as iron ore prices had started plummeting in 2013, leading CITIC to write-down Sino Iron by billions of dollars.

Macroeconomic risks

There are country-level macroeconomic risks around uncertainties about the economic and political stability and growth potential of another country's economy as well as the prospects for expanding bilateral trade, investment and flows of people and ideas.

China's economy faces a number of difficult, but inevitable, transitions. These transitions will benefit China and Australia significantly in the medium to long run (see Chapter 5). But in the short term, they have brought, and will likely continue to bring, adjustment costs as well as commercial opportunities for partners like Australia, and be the source of international economic shocks.

What are the potential impacts of shocks in the Chinese economy on Australia? There are two broad mechanisms between the Australian and Chinese economies through which shocks can be transmitted: trade and finance. Movement of people could be a third.

For trade, Australia will be negatively impacted by shocks in China that see a significant reduction in demand for Australia's major exports. It is instructive how relatively comfortably Australia has weathered a 60 per cent drop in the price of iron ore since the commodity boom burst.

Yet analysis from the IMF finds that Australia would be one of the worst hit advanced economy from slowing Chinese investment growth — only Iran, Kazakhstan, Saudi Arabia, Zambia and Chile could suffer bigger effects on their economies (Box 6.3).

Reducing reliance on investment and export-led growth is a key aspect of China's economic rebalancing and directly affects Australia. The IMF analysis suggests that for each percentage point decline in Chinese investment growth, Australia's potential GDP falls by 0.2 percentage points (Greber 2015). These estimates are built on the Chinese government's expectation that investment will fall steadily across the world's second-largest economy from 46 per cent of GDP to around 35 per cent over the next five to 10 years. This implies Australia's GDP could be 2 per cent below the levels that would occur if China's investment-led growth were to continue.

The projection is conditional on declining demand for Australia's mining and resources exports — other commodity exporting countries are also hit by this change in the Chinese economy. The analysis does not take into account the potential increase in Australian exports in other sectors, including services sector adjustments in the non-trade and import-competing sectors, nor associated responses in the Australian economy that can be achieved from improved engagement with China. It is an exercise that simply measures the immediate impact of a major shock to existing trade. Australian engagement and policy settings are therefore crucial to the final effect on the economy. If the exchange rate falls with reduced demand for established exports, there will be a fillip to expansion of other sectors. Crucially this will be assisted by more proactive re-positioning by Australia bilaterally, regionally and multilaterally to take full advantage of these opportunities. As shown in Chapter 5, Australia's economic flexibility allows these shocks to be absorbed without loss of the gains from trade.

For finance, direct investment and financial linkages through equity, bond, currency and property markets represent the key transmission mechanisms for shocks from the Chinese economies. Financial reform, capital account liberalisation and internationalisation of the renminbi will have a range of implications for Australia. They will bring deeper financial markets to the region, increased capital flows, a reduction in the cost of capital, and greater opportunities to supply financial services into these markets. However, they will also be a source of shocks to investment in Australia, Australian financial markets and Australia's macroeconomic situation.

BOX 6.3: AUSTRALIA'S REACTION TO SHOCKS FROM SHIFTS IN CHINESE MARKET SENTIMENT

Recent volatility in Chinese stock markets illustrates the way in which shocks can be transmitted through financial markets. China's stock market is still very underdeveloped and it plays a very small role in the economy. The stock market is about a third of GDP, compared with more than 100 per cent in developed economies. Less than 15 per cent of household financial assets are invested in the stock market. These shocks are, however, transmitted to Australia, causing volatility in Australian equity and currency markets and potentially hurting growth through wealth effects.

The ASX200, along with other indices globally and in the region, followed the downward trend in the Shanghai Composite through 2015. Commonwealth Bank China and Asia economist Wei Li asserts 'that China's financial market is becoming more integrated in global investor sentiment' (quoted in Desloires and Cauchi 2016). Analysis by Rodriguez and Ren (2015) finds that the Australian dollar is especially susceptible to volatility in Chinese financial markets. They find a 20-day correlation of 0.38 between the Australian dollar and the Shanghai Shenzhen 300, the largest correlation for any currency, including the Japanese yen.

A more significant financial risk is if there is a general loss of confidence by investors in China, potentially triggered by a broader loss of confidence in the emerging market economies given the challenges facing Brazil and Russia, in particular. Using an inter-temporal multi-sectoral DSGE (Dynamic Stochastic General Equilibrium) model called G-Cubed — the theoretical structure is outlined by McKibbin and Wilcoxon (1999) — the consequences of a 200 basis point increase in the risk premium of holding assets in emerging market economies could be significant for Australia.

The Australian economy is also in a period of transition. Capital, labour and other economic resources are moving from the mining and resources sectors towards other sectors of the economy. It is in Australia's interest to ensure that this reallocation of resources is carefully managed. The impact of a 200 basis point risk premium shock through a loss of investor confidence in China would be to speed up this change significantly. The earnings from Australia's mining and resources exports are already low compared to the mining boom period, and much of this demand comes from the emerging market economies. Reduced growth in these economies would see further contractions in demand for Australia's exports. Investment falls by 10 per cent in Australia's mining sector and 5 per cent in its energy sector (Greber 2015).

But on the financial side, capital flowing out of the emerging market economies flows into the advanced economies, including Australia. This appreciates the exchange rate by 3 per cent, which further exacerbates declining demand for Australian exports and weakens the trade balance. The capital flowing into the Australian economy favours the non-trade exposed sectors, which actually boosts investment in those sectors. Overall the shock has the effect of speeding up the economic transition in Australia through substantial reduction in investment and economic activity in Australia's trade-exposed sectors and increased investment elsewhere. Although, counter-intuitively, the net effect is marginally positive for Australian GDP (around 0.6 per cent), this shock tests the flexibility of the Australian economy and its ability to relocate capital and labour at a rapid pace.

The key policy message for Australia in considering how to deal with Chinese economic shocks is to underline the importance of having an open and flexible economy so as to manage these shocks and facilitate the smooth transition of the Australian economy. Australia's floating exchange rate, strong institutions and robust macroeconomic frameworks are critical. These need to be complemented with reforms to strengthen the flexibility of labour markets (particularly through improving workplace regulation and the education, training and re-skilling of workers) and product markets through microeconomic reforms to boost competition and reduce barriers to entry and exit.

System difference risks

There are system difference risks that create, among other things, uncertainties in sovereign behaviour towards private entities in other countries that are connected to policy frameworks and their stability (see Chapter 1). These uncertainties give rise to risks that are important to managing relationships in which the partners are undergoing rapid economic and social change. Within the bilateral relationship, these risks result from institutional and political differences as well as interest divergences between governments, and are embedded in the institutions and political and social behaviour of each country.

System difference risks and uncertainties derive from different histories, and from the economic and institutional transformations that both systems are undergoing. Even as the process of economic reform is further advanced, fundamental differences will remain between Australia and China in relation to political and legal institutions. The right of China and of Australia to determine and maintain their own political institutions, and defend their national sovereignty, is a premise in their bilateral relationship.

The Australian and Chinese governments recognise that they 'have different histories, societies and political systems, as well as differences of view on some important issues', but both countries 'are committed to constructively managing differences if and when they arise' (DFAT 2016a).

Australia is a multi-party liberal democracy. China is governed as a one-party state. Australia has a freewheeling media. China has a more controlled media environment. The Australian people provide input to their political system through regular representative elections. The Chinese people provide input to their political system through consultative mechanisms. The Chinese political and institutional system continues to change, with long-term goals for political reform, but there is uncertainty about when and how these goals will be delivered.

Australia is a federation, under a national Constitution of the Commonwealth. The federal government and state governments are separate political entities, whose parliaments are elected to be representative of the people in a system of multi-party democracy. Around 100,000 Australians are members of political parties. The Commonwealth Parliament has the power to pass laws subject to the Constitution in areas where it is competent. The prime minister and other ministers of state are drawn from the parliament and are subject to its laws. The government appoints judges, but the law is interpreted independently according to common law traditions. States have their own areas of jurisdiction. The economy is largely private. Whether a dispute is with another private company, a state or the federal government, it is settled according to this well-established legal framework.

China has a unitary political system under the leadership of the Chinese Communist Party. More than 80 million Chinese are members of the Chinese Communist Party. Since 2002, it has welcomed businesspeople as members. It guides the work of Chinese leading institutions, including the National People's Congress, and consults the people more broadly through the Chinese People's Political Consultative Conference (CPPCC). The general secretary of the Party is also the president of the People's Republic of China. The state and Party operate with respective formal constitutions. China is strengthening its system of laws and regulations at national and local levels. While a very large and dynamic private-sector economy has emerged (see Chapter 2), public ownership remains the foundation of key sectors of the state economy. Chinese company law requires companies to provide necessary conditions for Party establishments; however, only in SOEs does a company's Party committee play a formal leadership role in company affairs.

BOX 6.4: LANDBRIDGE GROUP AND THE PORT OF DARWIN

Under the relevant legal definitions governing Australian foreign investment, the Landbridge Group is a private company. Nevertheless, after the company was awarded a lease over the Port of Darwin in the Northern Territory, some security commentators raised alarms in the media about Landbridge's supposed connections to the Chinese government — in particular that the company has a Party Committee, and that its chairman is an advisor to and may be a member of the Chinese Communist Party.

But 1.63 million private companies in China have Communist Party committees — more than half of all Chinese private businesses — and millions of Party members work in China's private sector (Xinhua 2014). This is a natural result of China's political system, not evidence that companies are acting as agents of the state.

The Northern Territory government received A\$390 million from the proceeds of the A\$506 million lease awarded to Landbridge, and Landbridge has committed to spend a further A\$35 million on the port within five years and to invest A\$200 million over a 25-year period.

The structure of the sale of the Port of Darwin meant that only foreign government investors required FIRB approval. This was due to an exemption under the *Foreign Acquisitions and Takeovers Act (Cth) 1975* for asset sales by state and territory governments. Private foreign investors, including the Chinese private investor Landbridge, did not require approval.

To address any national interest concerns regarding the privatisation of the Port, the Department of Defence renegotiated a Deed of Licence with the Northern Territory government for defence access to the Port for the next 15 years with an option to extend to 25 years. The main naval defence base in Darwin, HMAS Coonawarra, was also excluded from the transaction.

On 18 March 2016, the Treasurer announced an amendment to the *Foreign Acquisitions and Takeovers Regulation 2015*, removing the exemption for private foreign investors acquiring an interest in critical infrastructure assets purchased directly from state and territory governments. From 31 March 2016, FIRB will formally review all critical infrastructure assets sold by state and territory governments.

These system differences can sometimes give rise to misunderstandings as well as be a cause of fundamental difference, but they need not be an obstacle to deeper trade or economic engagement. Chinese businesses investing or operating in Australia need to understand the political separation between different layers of government, and also be aware that in the context of representative government, the support of political representatives interacts with community attitudes and perceptions rather than dominating them. In addition, the support of elected representatives cannot be expected to facilitate the resolution of disputes or the conduct of business — that is determined by independent regulators and the courts.

In Australia, where fundamental political questions are resolved by legal interpretation, there is a tendency to categorise Chinese companies as ‘state-owned’ or ‘private’ based on black-letter provisions relating to equity-ownership. The boundary between Chinese political institutions, SOEs and private businesspeople is not always well defined or understood. Some Chinese companies, which are clearly private according to Australian legal definitions, are portrayed as being state-influenced because of family connections or historical links to the Party, the state or the military (Box 6.4).

Australia and China could further develop their legal frameworks to help clarify these issues over time. The legal framework of modern market economies, such as Australia, could provide useful assistance to China’s own reform commitment to improving rule of law. This could help reduce uncertainty for foreign investors coming into China, seeking partnerships with local businesses and negotiating the local regulatory environments (Box 6.5). It is imperative that businesses operating in either country are able to make commercial decisions that rely on a robust rule of law rather than requiring non-legal recourse to political connections and other irregular channels should any business or regulatory issues arise. It is also important that both countries allow for open access to resources that are shared by all nations, such as sea-lanes, the internet and space.

The development of corporate governance and transparency in the operation of Chinese companies, including SOEs, can also help inform their dealings in a foreign setting. Australia would miss an opportunity for positive engagement with China if its formal policy settings discriminated against SOEs as a matter of principle. And it could misinterpret China’s private sector were it to endorse a view that any company with links to the government was in some way commercially controlled by the state. Similarly, China will miss an opportunity if it widely and unnecessarily discriminates against foreign investment.

BOX 6.5: SINO GAS IN CHINA

Sino Gas and Energy Holdings (Sino Gas) is an Australian stock exchange listed company that explores for and produces natural gas into the Chinese market. Its competitive advantage is its skilled labour force and technological ability to drill and extract gas using advanced techniques at very low cost. Sino Gas has been operating in China since 2006 and is now Australia’s largest energy investor in China and one of only a small number of foreign exploration and production companies producing gas commercially into the Chinese market. Gas production commenced from its Sanjiaobei and Linxing Production Sharing Contracts (PSCs) in China’s Shanxi province in 2014. A total of approximately US\$310 million has been invested in the two projects by Sino Gas and its partners since inception. Production from its Linxing central gathering station commenced in September

2015, after being slightly delayed due to a central government directive requiring safety reviews of all gas operations country-wide following the media sensation over a deadly explosion in Tianjin.

A total of US\$10.1 million was received by Sino Gas' 49 per cent joint venture for gas sold from the Linxing PSC from December 2014 through to late February 2016. Proceeds for pilot gas sales from the Sanjiaobei PSC of approximately US\$2 million have been made to its PSC partner, PetroChina CBM. However, production at the Sanjiaobei Central Gathering station remains suspended while negotiations are underway on the final allocation of pilot production proceeds to Sino Gas' joint venture. This is expected to be resolved shortly.

The anti-corruption campaign in China has created some uncertainty, and slowed dealings between Chinese authorities, SOEs and foreign companies. In the Chinese system, regulatory milestones can sometimes require a matrix of approvals from different departments at the local, provincial and national levels. These are issues that would naturally be taken up in a new investment agreement between Australia and China and might build confidence in the investment environment. In the current environment, many of these approvals have taken slightly longer than in the past due to the increased scrutiny of decisions made by regulatory authorities and SOEs. Delays on the receipt of sales proceeds and regulatory approvals has impacted Sino Gas' share price, though ongoing technology transfer as well as the high-level support of the Australian government are hoped to insulate Sino Gas from excessive project delays in China. Notwithstanding, Sino Gas has been one of the better performing ASX listed exploration and production stocks over the past two years. The China energy sector remains an attractive value proposition for foreign firms and operators given the favourable fiscal and regulatory regime.

Sino Gas is an Australian success story and the longer-term prospects for the company are very bright because the Chinese central government is looking to double the gas contribution to its energy mix by the end of the next Five Year Plan in 2020. Full production from the company's assets is expected to commence in 2017, and by 2021 Sino Gas' assets will produce approximately 3 per cent of China's total domestic natural gas production, making it a significant contributor to the energy objectives of the country.

Across-the-board policies that discriminate against foreign companies in general, or state-owned companies in particular, run the risk of confounding strategic intent with what is the unremarkable and unthreatening product of basic differences in each country's political institutions. Where either Australia or China does adopt policies to protect their core sovereign interests, whether in critical infrastructure, telecommunications or media (as they both properly do), these policies should be targeted to mitigate the actual risks identified, regardless of whether the threat comes from foreign or domestic actors, and whether they are legally private or state-owned. This is why institutions that foster mutual understanding, transparency and common interests are critical to allowing the full flourishing of the potential economic relationship between Australia and China.

Enhancing mutual trust and understanding is a key objective of the proposed Comprehensive Strategic Partnership for Change. The Partnership will help achieve these enhancements and mitigate system difference risks through: increasing public and commercial capacities to understand how the systems of the other country work; more focused and more useful strategic official dialogues, for instance on regulatory cooperation, risk management and reform; and close high-level ties between political leaders who can 'pick up the phone' to reduce misunderstandings.

Reducing risks

Most of the risks facing actors within the Australia–China economic relationship are normal commercial risks, and the Australian and Chinese governments should properly entrust the management of these risks to market mechanisms, given the legal frameworks of their respective systems. The risks of commercial failures and macroeconomic uncertainty should be accepted and occasional business failures are to be expected and learned from. Some of these risks are bilateral system difference risks, which are structural in nature and can be mitigated through political dialogue, public institutions and bilateral cooperation. They occur because of: differences in interests among Australian and Chinese firms in their operations in the other country; the entrenched interests of regulatory actors and domestic firms in the other country, which may be motivated to limit foreign competition and preserve markets share; and the way institutional systems and social behaviour affect business outcomes.

High-level political leadership, building on structured advice from key official and private stakeholders, can use bilateral and international pressure to make progress against these vested interests opposing domestic reform (Box 6.6). As it is an advanced economy, Australia is a valuable partner able to work at the frontier of opening Chinese markets to new actors and creating partnerships to share expertise on managing change.

In a globalised world economy, domestic reform can be incentivised and reinforced by international commitments to growth-promoting economic liberalisation. This strategy preserves the sovereignty of economic policy, while helping to overcome resistance from entrenched domestic interests who might otherwise stymie reform.

Through the Comprehensive Strategic Partnership for Change, both Australia and China can take advantage of this strategy to advance their respective economic transformations. This could be achieved through Australia serving as a possible testing-ground for gradual liberalisations of Chinese services trade, investment and capital account flows. Australia and China are a suitable match because Australia is too small an economy to have a significant effect upon global activity but it is large enough and well developed enough to provide a reliable feedback mechanism.

A prime example of success with this strategy is China's accession to the WTO and Australia's approach to it. One of the key drivers of global growth since the 1970s has been the integration of the global trading system. Conventional notions of three distinct economic systems — the capitalist 'first world', the socialist 'second world' and the developing 'third world' — gave way in the 1990s to the idea of a single global economic system, guided within a common set of institutions based around the WTO, the IMF, the multilateral banks and other entities that derived from the postwar Bretton Woods system. Economies that opened themselves to the global economy grew faster — not only because their producers gained access to overseas markets, but also because international competition places pressure on governments to reform domestic economies.

China was a latecomer to this global trading system. While a key plank of China's economic reforms after 1978 was opening up to the outside world, making it an exemplar of 'export-led growth' in the 1980s, there was still great progress yet to be made in the mid-1990s. But China had been interested in joining the global trading regime since it first requested observer status at the WTO's predecessor — the General Agreement on Tariffs and Trade (GATT) secretariat — in 1980. China joined the multi-fibre agreement that regulated global trade in textiles in 1984, and in July 1986 China requested full status as a GATT contracting party.

China's GATT application was an early example of close practical cooperation between China and Australia in support of both countries' economic transformations. Australia had been encouraging China to join GATT from late 1985, and provided an advisor to China's Ministry of Foreign Economic Relations and Trade from 1986 to 1987 to assist in preparing the application. A GATT working party considered China's application from 1987 to 1996, and was concerned about many Chinese policies that remained as a legacy of the planned economy. These included then-high tariff barriers (averaging above 35 per cent), lack of transparency or uniformity in customs requirements, the absence of opening up of China's financial sector to foreign competition, subsidies for SOEs, as well as a lack of currency convertibility, labour standards and intellectual property rights enforcement.

BOX 6.6: CHINA'S ACCESSION TO THE WTO

At the Osaka APEC Summit in 1995, China committed unilaterally to one of the largest single trade liberalisations, as bona fides of its intention on the way to WTO accession. The Chinese premier visited the United States for negotiations in April 1999, and the presidents of both countries met at the Auckland APEC summit in September that year. Final bilateral negotiations between the premier and the American ambassador in Beijing resulted in a 250-page agreement that paved the way for China's full accession. All the while, Australian advisers worked closely with Chinese officials on the substance and tactics of achieving WTO membership (Garnaut 2005).

China's accession to full membership of the WTO in 2001 reduced the tariff barriers facing Chinese exporters, fuelling a boom in what had already been a fast growing sector. In 1980, China's share of global manufacturing exports was just 0.8 per cent. By 2001 it was already 5.2 per cent. Following WTO accession, China's share of global manufacturing exports grew by 1 percentage point per year, making China the source of 18 per cent of world manufacturing exports by 2014. This was not only beneficial for consumers of low-cost Chinese manufacturing products worldwide, but also a boon for raw materials suppliers such as Australia (Anderson et al 2014).

Just as significant as the growing market for Chinese exports was the external anchor that China's accession protocol provided for China's own domestic reforms. Commitments to phase out government subsidies for loss-making SOEs hardened the budget constraint in the state sector, improving SOE efficiency and therefore generating significant welfare gains over and above the trade policy effects. Commitments on transparency, intellectual property, finance and environmental protection also supported China's development (Bajona and Chu 2015).

Accepting WTO disciplines did not mean going against China's national policy interests. SOE reform, for example, was already well under way, with thousands of small and inefficient SOEs being closed well before WTO entry (Zhang and Freestone 2013). Nevertheless, by working towards and committing to standards in an international agreement, the WTO provided China's leaders with an external anchor with which to consolidate existing gains and to push for future reforms.

International commitments, from this perspective, are not 'concessions' that a country gives up in order to secure benefits elsewhere, but rather serve to secure the benefits that are delivered at home from win-win cooperation with international partners and institutions through which all countries can thrive (Sachs et al 1995). This is the philosophy that underpins a joint Australian and Chinese economic transformation.

While developing countries were allowed some leeway in meeting full GATT obligations before joining, the United States was reluctant to allow China to join either the GATT or the WTO until all these concerns had been addressed. Indeed, the protocols of China's accession to the WTO (for example on export controls) were in some respects stricter than those applying to existing members (Box 6.6). Rather than change policies suddenly and risk immense social disruption, China continued its policy of gradual and pragmatic liberalisation. Economic leaders in China saw the opportunity to prosecute China's domestic reform agenda by using WTO requirements to force change in sectors that resisted opening to competition, and so pledged reforms in these areas in exchange for US agreement.

Managing risk

All the risks that business and countries face in other markets are susceptible to amelioration by a range of strategies. Commercial risk, associated with uncertainty about future prices or incomes, can be managed by contracting and exchange hedging strategies, and importantly by investment in the acquisition of market knowledge (Box 6.7). Through international agreement or treaty, governments can provide protection against capricious policy behaviour that increases economic risks.

The Australia–China relationship has been built around enshrining market principles in the two countries' bilateral and global approach to trade, investment and finance, and working to remove impediments to the operation of market forces so as to improve the efficiency of commercial exchange and therefore enhance growth prospects.

Yet business relies on access to information about, and analysis of, the events and trends that influence the formation of efficient market outcomes, and nowhere is this more the case than in the discovery and development of new and prospective markets. Governments are one source of information and analysis, but building reliable and independent centres of analysis in universities and think tanks, which can inform firms of trends and developments likely to affect market outcomes, provides another important source. The Comprehensive Strategic Partnership for Change should encourage investment in national centres of excellence in analysis to support understanding of the forces that will shape the development of the economic relationship between Australia and China in its regional and global settings. That will ensure it has the necessary intellectual underpinnings to thrive.

In Australia, the ANU houses one of the strongest concentrations of research expertise on the Chinese economy outside of China. Each year its China Economy Program (CEP) publishes a peer-reviewed edited volume of international research on the Chinese economy — the China Update series — and hosts a major conference that brings together Chinese, Australian and international academics and policymakers to discuss its findings. Yet even the CEP would need to be significantly strengthened into a truly national endeavour — through cooperation and research collaboration with official agencies in Australia and China as well as through routine links with other centres of research in Australia and internationally — if it were to play a lead role in implementing a strategic research agenda that connects its bi-national economic scholarship directly to the practical advancement of the economic transformation occurring between the two countries.

The important role that independent academic interlocutors can play in reinforcing the validity of market approaches on both sides is revealed in the communication breakdowns, institutional confusion and resultant mistrust that characterised the explosion of the price boom in iron ore exports from Australia to China from around 2007 to 2012.

The CEP in Australia could appropriately serve as a foundation for a network of research capacity, due to its existing work and its deep connections to equivalent Chinese centres such as the National School of Development at Peking University, Renmin University's National Academy of Development and Strategy, the Chinese Academy of Social Sciences and the Center for China and Globalization. Processes such as those set in motion by this collaboration between CCIEE and EABER can add momentum and direction to these efforts.

BOX 6.7: DELIVERING PROSPERITY AND SECURITY THROUGH THE MARKET

In the early 2000s, the global market for iron ore had to adjust to a large positive demand shock from China, which required enormous amounts of iron ore to build the housing and infrastructure needed to sustain rapidly expanding urbanisation and industrialisation. As international supply struggled to keep up with soaring Chinese demand, and high-cost marginal producers in China and other countries entered the market to fill the supply gap, the price of iron ore was pushed up to record-high levels by 2011.

The magnitude of the increase in iron ore prices, led some to suspect that the 'Big Three' major intra-marginal iron ore suppliers — Rio Tinto and BHP Billiton in Australia and Vale in Brazil — were taking advantage of China's iron ore shortage by engaging in strategic supplier oligopolistic behaviour to extract super-normal profits. Natural constraints on the expansion of iron ore production caused a short-run supply gap following the surge in China's iron ore demand, combined with pre-existing market conditions and delayed price signalling.

The iron ore market adjusted to the demand shock in a competitive way in the longer run. Up until 2009, the global iron ore price was set by a benchmark pricing system, which involved direct negotiations between contract holders — for example Australian suppliers and Chinese buyers — and delivered internationally competitive pricing outcomes. In 2009, the state China Iron and Steel Association (CISA) intervened in annual iron ore price negotiations by threatening to boycott Big Three iron ore imports unless a below-market price was agreed. This intervention failed because Chinese importers were dependent

on Big Three supplies, the intervention was therefore not supported by the central government or by the steel business, and the threat could not be enforced because of the competitive nature of the domestic industry and the international market.

This episode created unnecessary tensions in the bilateral economic and political relationships. It also led to the collapse of the benchmark pricing system, which was replaced by a spot market pricing system. This change altered how bilateral quasi-rents from geographic closeness were distributed between Chinese and Australian iron ore traders. In the first 21 months after the switch to the spot market price mechanism, Australian exporters received, on average, a gain of around US\$288.3 million per month, as compared to what they would have received under the 2008 pricing system. The division of bilateral quasi-rents is a zero-sum scenario, meaning Australia's US\$288.3 million average gain per month meant that China's iron ore importers from Australia lost US\$288.3 million per month. For context, during this period, China's steel industry made an average profit of US\$1.1 billion per month (Hurst 2016).

The Australian and Chinese systems would have profited during this earlier phase of economic transformation from having direct policy access to an independent centre of economic research excellence that was dedicated to furthering bilateral relations based on market principles.

Policy uncertainty and its impact on businesses and whole economies is never absent, even between countries that have the most familiar and institutionally similar market structures, and even when governments have a range of macroeconomic instruments and policy settings to cushion against unexpected shocks from other economies while preserving the gains from exchange. These macroeconomic instruments notably include flexible exchange rates, sound macroeconomic policy strategies, and access to reserves and international support from the IMF or major economic partners.

High volatility on the Chinese stock market and the slowing headline growth figures are sources of uncertainty. Also, some of the public reactions to economic news from China is noise and could affect short-term decision-making. But reasoned commentary that is informed by close working relationships at the official level and serious independent analysis — for example, of the role of key developments in each country such as stock market variability or market developments — are essential to balanced and measured responses to events that prevent market and policy stakeholders in each country from being diverted by non-significant signals and misreading underlying trends.

A new and rapidly expanding partnership requires private and public investment in developing knowledge, literacy and understanding both to maximise opportunities and to protect against risks.

An Australia–China Comprehensive Strategic Partnership for Change

When the Australian prime minister visited China in April 2013, the two countries announced that they had established a 'Strategic Partnership'. They agreed to have regular meetings between the Chinese president and the Australian prime minister and to hold three high-level annual bilateral dialogues: a Leaders' Meeting between the Australian prime minister and

the Chinese premier; a Strategic Economic Dialogue between the Australian treasurer and trade minister and the chairman of the NDRC; and a Foreign and Strategic Dialogue between the Australian and Chinese foreign ministers. In November 2014, when China's president visited Australia and met with the Australian prime minister, bilateral ties were upgraded to a 'Comprehensive Strategic Partnership'.

This diplomatic nomenclature is not unique to Australia, but is part of the 'partnership diplomacy' that is the foundation of China's 'non-alignment policy' in international affairs. To be a 'partner' of China requires a level of mutual trust, an absence of fundamental differences on the major issues of territorial sovereignty such as Tibet, Xinjiang and Taiwan, and an importance to China in strategic, security or economic issues. Of the more than 170 countries that have diplomatic relations with China, less than 60 are 'partners'. Unlike alliance relationships, China's partnership relations are announced in joint statements rather than enshrined in treaties.

China's partnerships mostly fall into four categories, which in order of ascending importance are: cooperative partnerships; comprehensive cooperative partnerships; strategic partnerships; and comprehensive strategic partnerships. The term 'comprehensive' indicates that a country collaborates with China across a broad range of spheres, including politics, economics, culture and military affairs. The term 'strategic' signifies that a country works with China at a high level on issues of common interest that have a global dimension and which impact the overall blueprint of each country's international policymaking. Strategic partners are considered to be reliable colleagues and to share similar strategic objectives in transnational arenas. Countries tend to start at lower levels and work their way up over a period of many years.

In this ranking, China already recognises the strategic importance of relations with Australia. Yet China has 'comprehensive strategic partnerships' with over 20 other countries, including countries that are seemingly of far less economic, political and strategic consequence to China, such as Algeria and Peru. Indeed, certain countries of special importance for China have their own unique classification within China's partnership diplomacy. Russia is a 'comprehensive strategic coordination partner'. Pakistan is an 'all-weather strategic cooperative partner'. The Indo-China Peninsula states of Vietnam, Laos, Cambodia, Myanmar and Thailand are 'comprehensive strategic cooperative partners'. Germany is an 'all-around strategic partner'. The United Kingdom and China recently declared a unique 'global comprehensive strategic partnership for the 21st century'. For various reasons, neither the United States nor Japan is part of China's formal 'partnership' system.

Given the developments in the relationship and its prospects, Australia and China should now contemplate upgrading their partnership to a unique 'Comprehensive Strategic Partnership for Change'. This would send an important high-level message that Australia and China extend trust to each other as partners in a working relationship that aims for substantial change towards significant mutually agreed goals and objectives. Already, only much larger countries such as the United States, the United Kingdom, Russia and Germany have an equal or greater level of regular interaction with the Chinese political leadership. Australia's placing in China's partnership system shows that both the Australian and Chinese polities recognise how important the other country is to the other. Now is the time to convert this bilateral understanding and existing bilateral dialogues into closer economic and political cooperation.

Bilateral political meetings are part of a process of developing understanding and trust, improving policy coordination and creating norms of consultation between Australia and China. These are crucial both to capitalising on bilateral policy arrangements such as ChAFTA, and to establishing confidence in being able to communicate during situations where there are difficulties in the relationship or crises to be managed. Importantly, as partners for change, both Australia and China will work across a range of priority areas on a common language for framing and advancing bilateral relations, and entrenched procedures for notifying the other side about upcoming policy announcements and developments that affect mutual interests. This ensures, as far as possible, that there are 'no surprises'. Frequent high-level political leadership meetings, frequent senior bureaucratic meetings, and deep levels of working relationships characterised the rapid development of bilateral relations in the 1980s, and they are the key to success in the relationship in all its dimensions in the decade ahead.

The revitalising visit by the Chinese vice-premier to Australia in October 2009 set the tone for the future relationship. That visit followed two difficult years in the bilateral relationship (Australian Centre on China in the World 2015): Australia's then prime minister referenced human rights problems in Tibet during a speech at Peking University; Australia's 2009 Defence White Paper ignited controversy by concluding that China's military modernisation could be 'cause for concern' and was 'beyond the scope of what would be required for a conflict over Taiwan'; Chinalco's bid for an increased stake in Rio Tinto fell through; a Rio employee was arrested in China on bribery charges; and a Uighur leader visited Australia. Yet Australia and China agreed on a 'blueprint for the further development of China–Australia relations' and this visit is widely credited with laying a new foundation for stable bilateral ties and improved political relations. It led to an 'Australia–China Joint Statement', in which both sides agreed that 'stronger practical cooperation for mutually beneficial outcomes serves the fundamental interests of the two countries', and committed to 'sustain and enhance their dialogue, engagement and cooperation at all levels, including the senior leadership level' (Australian Embassy China 2009). This outcome is an exemplar for the future of the bilateral relationship.

A new partnership for change between Australia and China that supports the economic transformation in both countries can only work if institutions and arrangements are jointly put in place to sustain regular engagement and targeted policy initiatives that are ahead of the curve of reform. These institutions can aim at entrenching a culture of cooperation within the relationship, both from the top-down through political leadership and from the bottom-up through official and private initiatives, and through combinations of both.

As the Australian prime minister said in 2013, 'new architecture will not do the work for us or make hard problems in our relationship easy', but 'what it will do is elevate our existing habits of dialogue and cooperation' (Kenny 2013). Australia and China can give substance to their Comprehensive Strategic Partnership and signal commitment by raising it to a new and unique level.

A purely transactional approach to bilateral relations is in neither Australia nor China's interests. This is because, from its modern beginnings, the Australia–China relationship has been premised on both countries' ambitions for reform and change. From the opening of diplomatic relations to the prospects we have laid out for the decades ahead, managing change on a huge scale has been, and will continue to be, the premise of the success of the relationship. As this Report makes clear, this requires long-term commitments and

institutions that help to frame common principles and reference points for progress in the relationship that help with the project of managing change, around all the uncertainties and risks that are its inevitable by-product. This change will bring prosperity and security not only to Australia and China but also to our region and the world.

In building new diplomatic architecture for the Australia–China relationship, it is instructive to examine the history of Australia–China cooperation, and particularly its high watermark in the 1980s (Garnaut 2005). Following the establishment of diplomatic relations in 1972, bilateral ties flourished, and with the launch of China’s opening and reform phase from 1978 the level of political engagement and economic collaboration between the two countries reached a peak during the 1980s.

During the 1980s, East Asia was central to the international dimension of Australia’s own economic reform; at the same time, China was opening up to the world through its first round of market reform. Australian political leaders and their advisers directed efforts to linking Australia’s domestic reform process to that occurring in China. The foundations laid by high-level political visits, government visits, policy discussions, exchanges and joint working groups encouraged greater engagement by private business, state enterprise and other economic actors.

In the early 1980s, the Australian government recognised the enormous potential for bilateral economic benefits if China could grow its domestic economy rapidly and create transitional institutions that secured for foreign actors rules-based access to the Chinese market. This was seen as an important way to ensure that China exercised its growing future power through constructive multilateral dialogue.

The bedrock of the relationship during the 1980s was the personal interest of and exceptional access between top leaders. This closeness was due to the initiative of previous Australian prime ministers and sustained official commitment. In Beijing in February 1984, the Chinese premier suggested, and the Australian prime minister accepted, that the two countries should aim to create a ‘model relationship’, one where Australia–China relations became a model for how countries with different political and social systems and at different levels of economic development could interact.

During this time, China needed to open up to the world, and Australia wanted the credibility that could come from showing that it was acting consistently with its prescriptions for China. So while the ‘model relationship’ included the important qualifier that there would be no special privileges — just equal rights, treatment and access — both sides committed to implementing all promises and commitments made under the model relationship.

Economic relations were central to this model relationship. A strategic China Action Plan was developed following discussions between the Australian prime minister and the Chinese premier in 1983, and was agreed in Beijing in February 1984. It committed to advancing trade and investment in both directions. In Australia, the Plan set an objective of doubling the value of Australian exports to China within five years, and took into account China’s desire to expand imports to Australia. The Plan’s target was reached in only two years.

Under the Plan, Australia decided to maximise its impact in China by focusing engagement and government follow-through on a small number of industry sectors and Chinese provinces. The four key export sectors for Australia were: iron and steel, non-ferrous minerals and metals, wool and grain. In February 1984, Australia and China established a Joint Working

Group on Iron and Steel. Similar groups were formed for non-ferrous minerals and metals, and for wool, and China agreed to soften its grain self-sufficiency targets. China made its first two major overseas investments in Australia — a brownfield investment in the Portland aluminium smelter in Victoria and a riskier greenfield investment in the Mt Channar iron ore mine in Western Australia.

The Plan significantly reduced commercial risks for Australian enterprises dealing with China by providing high-level political support for major projects, establishing working relationships and conducting regular visits with key officials in target areas, obtaining information regarding the project and reform priorities of provincial and local governments, and making introductions between firms and relevant officials.

Australia invested considerable effort in creating business and public sector capacity for analysing the trade, investment and other opportunities in the China relationship. Australian diplomatic officials strived to understand complex decision-making structures and built effective relationships with the large number of Chinese policymakers with effective veto power over reforms. The Australian Embassy was able to help obtain authoritative responses to major Australian business proposals. Australia and China worked together closely on cultural exchanges, immigration normalisation and regional nuclear non-proliferation.

Although it was recognised towards the end of the decade that, as China became more powerful and its ties with the major industrial countries expanded, it would be increasingly difficult for Australia to sustain the structure of its relationship with China, the Australia–China relationship continued to have a special if diminished place in both countries’ diplomacy. Competition increased as other countries sought to participate in China’s economy. Inflationary booms and growth corrections in both countries in the late 1980s shifted attention from international to domestic markets, and several major players shelved their bilateral investment plans. The reform pace of the Chinese economy slowed for a variety of reasons, creating uncertainty for business.

Three decades later, looking back at the foundations of the Australia–China economic relationship gives insight into what is needed for future success in the relationship. High-level political commitment is essential, as is high-level bureaucratic support. Bi-national collaboration on reform and change is critical. Strategic frameworks, such as the Comprehensive Strategic Partnership for Change, will be vital to setting the pathway forward.

Both Australia and China aspire to be leaders in economic reform and can support each other in this common objective. An upgraded and unique bilateral architecture aligns both with the Australian government’s commitment to an ‘Ideas Boom’ under its National Innovation and Science Agenda and with the Chinese government’s prioritisation of innovation in its 13th Five Year Plan.

The next phase of the two countries’ relationship needs to build on established trust around shared and common interests in their economic and political relationships, manage the uncertainties and risks from change, and develop deeper, up-close commercial and business engagement as the structure of the economic relationship shifts towards services and consumers. It will flourish all the more if both countries succeed in continuing to nurture in their societies a culture of cosmopolitan human capital that is literate in the business, society and discourse of the other country.

Dialogues

Top-level political leadership meetings signal, and ideally improve, the overall tenor of the Australia–China relationship. They normally occur only once each year, although there is scope for significant additional contact on the margins of the many international leaders and key ministers meetings that now exist.

Since 2014, Australia and China have held two iterations of an annual 1.5-track dialogue known as the Australia–China High-Level Dialogue (HLD), which is a recasting of the 1.5-track Australia–China Forum held annually from 2011 to 2013. Representatives of government, business, academia, think tanks and non-profit organisations attend from both sides to ‘consider the future shape and direction of the relationship’ and ‘how to deepen our ties across the breadth of our common interest and priorities’ (Bishop 2015). Engaging a diversity of bilateral stakeholders in semi-official dialogue mechanisms is useful, but the HLD is broad and its focus diffuse, so it does not lead to concrete outcomes or conceptual advancements in bilateral relations. This is in keeping with the aim of the HLD to enhance mutual understanding and provide a platform for developing ideas for the relationship, but real progress requires sustained high-level attention married to intensive joint working arrangements between the relevant agencies associated with specific policy issues.

The government assists specific industries in bilateral engagement through the coordination of support across related government departments. For example, the Department of Agriculture and Water Resources administers an Australia–China Agricultural Cooperation Agreement (ACACA) for target groups in the agriculture, fisheries and forestry sectors that are looking to enhance cooperation and develop linkages with China. This agreement offers opportunities for Australian businesspeople to visit locations within China and to make business contacts that might otherwise not be possible. To enhance the value of the program for Australia, delegates are required to share key lessons and contacts from their visit with their broader industry.

The Australia–China Council (ACC), established by the Australian government in 1978 with the Secretariat located within DFAT, plays an important role in fostering bilateral cooperation and people-to-people relations by activities including funding Australia–China initiatives that broaden and strengthen Australia’s engagement with China, Hong Kong, Macau and Taiwan in the ACC’s priority areas of economic diplomacy, education, and arts and culture. The ACC has been at the forefront of establishing private sector linkages to support Australian studies through the creation of the Foundation for Australian Studies in China (FASIC), which supports the BHP Billiton Chair in Australian Studies at Peking University, along with a network of over 30 Australian Studies Centres in China.

The youth sphere is another area in which both sides, often with official support, have progressed the development of valuable bilateral dialogues and community organisations that help to connect young Australians and Chinese across disciplines and across linguistic divides. The Australia–China Youth Association (ACYA) is a volunteer organisation which promotes bilateral youth engagement and provides community, careers and education opportunities for over 5000 Australia and Chinese students and young professionals across more than 20 chapters in both Australia and Greater China. The Australia–China Youth Dialogue (ACYD) is a marquee annual event that brings together emerging Australia and Chinese leaders from different fields to forge ongoing professional networks and collaborations. The Australia–China Young Professionals Initiative (ACYPI) is the premier

platform for young professionals in Australia and China to engage with the most significant issues of the bilateral relationship. The Australian government has invested in all of these initiatives, and their long-term benefit to the bilateral relationships will become more apparent as their alumni become the next generation of leaders in Australia and China.

The Australia–China business dialogue is primarily driven through the Australia China Business Council in China and the Australian Chambers of Commerce in China. These organisations are committed to advancing business and trade between Australia and China and do so through lobbying governments to remove barriers to bilateral commerce, providing business introductions and networks for members in both countries, and maintaining research programs that feed into events, advocacy and publications. The Australian government also runs a biennial Australia Week in China (AWIC) that coincides with state visits to China by the Australian prime minister. The AWIC involves a federal- and state-leader headed delegation of several hundred Australian businesses that participate in sector-specific programs of seminars, site visits, product showcases and networking events with Chinese firms and officials. These initiatives form a good basis for cooperation, but they would be improved through more bilateral involvement that commits senior Chinese business leaders to ongoing strategic cooperation.

BOX 6.8: MODELS OF BILATERAL COLLABORATION

Some models of productive bilateral collaboration in other areas that could be emulated in business and commercial affairs include:

The Australian Open: In 2015, the Australian Open tennis tournament, which has long positioned itself strategically as the ‘Grand Slam of the Asia Pacific’, signed a ‘friendship agreement’ with the Shanghai Rolex Masters to share resources and engage in joint promotional activities. China is a growing market for tennis participation, spectating and sponsorship, and there is already significant Chinese interest, attendance and marketing at the Australian Open. ANZ and Rolex are major sponsors of both tournaments, and the friendship agreement will enable staff exchange and combine the two events’ platforms to promote bilateral tennis tourism. The 2016 Australian Open was ‘launched’ in Shanghai in October 2015. Additionally, the Australian Open has launched a WeChat account, opened an office in Hong Kong, signed agreements with 12 Asia Pacific broadcasters, and engaged China’s only Australian Open champion, 2014 women’s singles winner Li Na, as a brand ambassador.

The National Library of Australia (NLA): The NLA partnered with the National Library of China (NLC) to compile and curate the ‘Celestial Empire: Life in China, 1644–1911’ exhibition that showed exclusively at the NLA in Canberra from January to May 2016. The exhibition featured precious artefacts from China’s last imperial dynasty that were displayed outside of China for the first time, as well as rarely seen treasures from the NLA’s own Chinese collections. To complement the exhibition, the NLA also hosted a series of academic lectures and community educational activities to increase public interest in and understanding of China. The exhibition was also expected to boost tourism to the Australian Capital Territory (ACT). The NLA received promotional support from the ACT government, building on previous partnerships between the two entities, on the 15-year sister-city relationship between Canberra and Beijing, and on an NLA–NLC MoU

agreed in 2012. The NLA also received support from the Australia-China Council and from a number of corporates, which were either building relationships with China or of Chinese origin and seeking to build their profile in Australia.

The Sydney Symphony Orchestra (SSO): Billing itself as 'the leading cultural ambassador for Australia', the SSO signed a MoU with the Shanghai Symphony Orchestra and the Shanghai Orchestra Academy in April 2015. The MoU formalises the commitment of each party to their ongoing relationships and will see regular performance tours between the two cities. The SSO will also provide mentoring and performance opportunities to Chinese students in Sydney in Shanghai. The SSO already has MoUs with China's National Centre for the Performing Arts, Guangzhou's Xinghai Conservatory of Music and the Guangzhou Opera House.

The business relationship does have a dedicated high-level dialogue mechanism in the Australia-China CEO Roundtable, which held its first meeting in 2010. The Roundtable meets on the side of leader-level state visits and discusses possibilities for deepening bilateral trade and investment. It is a worthy initiative but it might be of greater service to business engagement if there was effective inter-sessional pursuit of targeted agendas for enhancing business relationships and if there were a secretariat that could sustain a cooperation agenda and program of forward work. The Australia-China Senior Business Leaders' Forum, which is a purely business-to-business dialogue also provides another forum for corporate leaders to advance discussion and policy recommendations on bilateral challenges and opportunities on the occasion of Australia-China state visits.

The essence of a bilateral strategy should be to work together to achieve common objectives rather than having meetings for their own sake, and so the positive sentiment and resources behind the HLD might helpfully be deployed in more targeted ways. This could be achieved by holding a range of HLDs, each focused around bringing together bilateral counterparts in a particular area to deliver specific outcomes. A good model could be the Australia-Japan Public-Private Policy Dialogue (AJPPPD), an initiative of the Australia-Japan Business Cooperation Committee (AJBCC), which focuses specifically on promoting Australia-Japan infrastructure cooperation and has led to successful investments by Japanese firms in Australian infrastructure projects. The Australian-American Leadership Dialogue (AALD) also organises several events each year that focus on defined themes.

A number of successful official dialogues exist between Australia and China that could be a template for the many sub-components of an Australia-China Comprehensive Strategic Partnership for Change. The Australia-China Human Rights Dialogue, which was initiated in 1997, institutionalises official discussion of sensitive political issues in a structured, systematic and productive fashion. It provides a mechanism for raising specific and difficult issues in a quietly productive atmosphere, and seeks to resolve rather than draw attention to problems. In addition to supporting existing commitments, the Dialogue can be used to inform parties about future reform. The Dialogue also interacts with and complements the work and resolutions of multilateral human rights organisations, such as the UN, and works with NGOs. The Dialogue strengthens multilateral commitments while allowing Australia and China to discuss human rights in a collaborative setting and display a commitment to action in domestic medias. It also houses other relationship-building initiatives. The Human Rights

Technical Cooperation Program, which operates under the Dialogue, facilitates collaboration between the Australian Human Rights Commission and partner organisations in China, such as the All-China Women's Association and the Beijing Legal Aid Organisation.

Such Australia–China collaboration is an example of targeted cooperation that delivers specific objectives that have a broad appeal across the Australian and Chinese communities, and will therefore create a multiplier effect on broader bilateral ties. More strategically focused planning of official dialogues, and support for non-official dialogues, will form well-calibrated partnerships between Australians and Chinese at the forefront of economic transformations and social exchange that can better advance bilateral goals set at the political partnership level.

As well as the direct differences in cultural, institutional and political systems, there are additional questions of how governance systems impact on commercial exchange and what protocols and arrangements can be developed to help build understanding and trust between both countries.

Australia and China have a wide range of bilateral mechanisms including regular ministerial meetings, political exchanges, taxation agreements, disaster relief cooperation and cultural exchange programs. Increasingly targeted, strategic bilateral engagement in priority areas of economic transformation will increase trust, share knowledge of reform processes and implement practical collaborations that facilitate greater trade, investment and financial linkages in line with the direction of each country's transformation. Bilateral business councils, professional associations and forums build relationships between business leaders while providing a platform for sharing in-country expertise. High-level meetings in government and business encourage flows of people and ideas, and collaboration on policy outcomes.

Bilateral policy institutions such as the Australia–China SED bring together top ministerial-level policymakers to address a strategic agenda. The inaugural SED dialogue, held in 2014, focused on closer financial cooperation, advancing offshore renminbi market development, and highlighting areas of potential collaboration during the two countries' G20 and APEC host years. The following year, the dialogue specifically addressed investment opportunities in Northern Australia, including discussion of the prospective role of the AIIB.

Yet the most productive bilateral interaction is likely to be maintained within treaty frameworks because these regularise dialogue and objectives. For instance, there has not been a meeting of the Australia–China Human Rights Dialogue — which is not embedded in a treaty — in over two years, since the 15th meeting in February 2014.

The most important bilateral treaty currently in effect between Australia and China is ChAFTA. It locks in bilateral commitments to market opening and sets a definitive timetable for future consultations to further these reform commitments, thereby creating incentives for continuing dialogue and for finding cooperative solutions to opening up each other's economies.

The next step for Australia and China is to expand this closer relationship beyond just the economic realm through embedding the Comprehensive Strategic Partnership for Change.

Ironically, when China was a more closed economy and society, political system differences were clearer and engagement through trade and investment (involving directly state-owned entities) may seem to have been conducted in a more certain environment, albeit one that vastly limited the possibilities for exchange and investment. As China has become a more

open and complex society, there appear to be more uncertainties and attendant risks. This is a 'quality' problem associated with greatly elevated openness and opportunities for business around the successful accretion of China's economic power. This circumstance requires engagement, not retreat, in order to take advantage of the new opportunities presented by China's increased opening on many fronts.

Bridging the distance

Political and institutional system differences can make it difficult for countries to develop the certainty and confidence necessary to commit to long-term policy endeavours and investment projects. In Australia, different systems of governance, perceptions of human rights, cultural values and regional security issues increase feelings of distance from China. In China, misreading the hostile attitudes of some in Australia to investment projects, lack of knowledge about how democratic systems work and doubts about regional security strategies similarly creates distance.

Australia and China have very different social traditions, systems of government and business cultures. Consequently, a most important aspect of improved bilateral relations and the successful realisation of a Comprehensive Strategic Partnership for Change is developing deeper relationships between Australian and Chinese people — whether they be political leaders, departmental officials, corporate employees, or communities of migrants, tourists, students and citizens. Initiating and consolidating these relationships requires mutual trust and a deep understanding of how the other country works. Improving this stock of human, social and cultural capital should be the goal of 'China literacy' for the Australian system and the goal of 'Australia literacy' for the Chinese system. It is critical to be able to understand another country on its own terms — 'seeing out from the inside' as well as 'looking in from the outside' (Loubere 2016).

It is only through knowledge of the political institutions, economic system and sociocultural circumstances of the other country that a bilateral strategic partnership can fulfil its potential. This means that more people on both sides must be able to speak the other country's language, understand the other country's thinking and contemporary debates, and be able to contribute to the national life of the other country. This will require significant investment in education, realignment of bureaucratic, corporate and non-profit career paths, and the deepening of interactions between the peoples of Australia and China.

Presently, Australia's assets for understanding China are less well developed than they will need to be. While Australia may have been highly adept at exporting resources to China, building a commensurate relationship in manufactures and services will depend on greater China capabilities. While resources trade relies on the 'hardware' of extraction technology and transportation infrastructure, manufacturing and services trade is dependent on the 'software' of sales, marketing and design. Without knowledge of the tastes, preferences, hopes and fears of another society, businesses are unable to effectively position themselves to take advantage of that market or efficiently use marketing and promotional resources.

This highlights the crux of the major problem that Australia faces: while it can provide more Chinese people with high-quality, English-language education, it cannot simply assume a linear rate of progress in other areas of Australia's services industries without addressing Australia's capacity to develop services expertise. There have been constant calls from

within the business, policy, academic and education sectors for Australia to increase its 'China literacy' — a concept typically described as the knowledge and skills necessary to 'understand' China and navigate cross-cultural social and professional interactions.

The *Australia in the Asian Century White Paper* (2012) and bodies as diverse as Asialink, the Australian Industry Group, the Australian Public Service Commission and the Business Council of Australia have argued that there is an 'absence or underdevelopment of critical individual and organisational capabilities' on Asia. More Australian students are studying Chinese today than ever before, but most are of Chinese heritage. Authoritative reports tell us that Chinese classes are 'overwhelmingly a matter of Chinese teaching Chinese to Chinese' (Asia Education Foundation 2008). Excluding first language and heritage speakers, more Year 12 students study Latin than Chinese as a second language. A recent report estimates that there are less than 150 Australians of non-Chinese heritage who can speak Chinese fluently (Orton 2016). It would be sensible to resurrect and properly fund the recommendation of the Asian Century White Paper to provide Australian school students with continuous access to priority Asian languages throughout their education.

It is difficult to imagine how Australia can fully grasp China opportunities in the services sector without either encouraging the targeted immigration of skilled Chinese, without speaking Chinese, without understanding Chinese society and without knowing the Chinese regulatory environment. And the need of services firms for China (and Asia) literacy will only grow (BCG 2012). Logistics company Linfox notes that it 'faces the challenges of running a large, complex organisation in multiple geographies and cultures ... 12,000 of Linfox's 19,200 employees are now in Asia (only 13 are expatriates) and 20 different languages are spoken across the firm' (BCG 2012). All Australian firms need the services capacity to face challenges similar to those of Linfox.

One, often underexplored part of this problem, comes down to business. If business wants a workforce with China skills (or 'China literacy'), business needs to create a market for this workforce. It is estimated that, the resources sector aside, Australia could lift its economic performance with Asia by up to A\$275 billion over the next 10 years by improving Asia capabilities (Asialink 2012). The Australian Department of Industry, Innovation and Science has mandated Asialink Business as Australia's National Centre for Asia Capability, to support Australian organisations to develop the knowledge and networks needed to engage with Asian markets, including China. It has made progress towards cultivating a more China capable workforce through initiatives such as the China Country Starter Pack to fill the gap in China information available to Australian businesses and training over 5000 professionals across the country annually.

Even today, very few managers in Australia have developed the time-consuming specialist language, cultural and analytical skills that are necessary to be China-literate. Another shift has to come in how graduates are recruited at the entry-level of business and public service. Very few jobs ask for specialist China-literate skills, focusing instead on 'generalist' skills. But the higher the proportion of China-literate senior leaders, the more likely businesses (or policy agencies) will perform above expectations. With this in mind, Australia needs to think about how to best use the China skills that it already possesses. For example, a starting point would be to provide young Australians in industry, government and other professional careers with pathways that allow them to maintain and improve their China skills.

China literacy is not determined either solely or even necessarily at all by one's level of Chinese-language proficiency. Perhaps even more importantly within the ranks of corporate leadership is an understanding of how to do business in China, where personal networks and influence is key to building trust with potential partners. A former Australian ambassador to China has opined that the most important aspect of China-literacy for Australian businesses is investing high-level time and effort in maintaining relationships with commercial partners and government officials through visiting China and through inviting Chinese partners to spend time in Australia, as well as putting serious resources into training and retaining appropriate bicultural talent (Raby 2011).

It is true, of course, that Australian and Chinese firms operate a market for China literacy, and this can be assumed to be working — these businesses will structure their hiring and management practices as needed to attract the necessary talent. But the ambitions of Australian and Chinese companies in this area are constrained by the supply of bicultural and bilingual workers that emerge from each education system. It is in relation to public institutions such as schools that governments have a role to play in investment in China-literacy and Australia-literacy as a public good.

An asset that appears underutilised is the language and cultural skills of many people of Chinese descent living in Australia. Of 22 million Australians counted in the 2011 Census, close to one million had some form of Chinese ancestry. Australians with Chinese heritage comprise 4 per cent of the total population and 44 per cent of the Asian Australian population, with Sydney and Melbourne the major centres of concentration of Chinese Australians. Since 2011, mainland China has been the largest source of permanent migrants to Australia, and there are now 319,000 Australian residents who were born in mainland China — the third-largest foreign-born ethnic group — as well as 75,000 born in Hong Kong, 25,000 born in Taiwan and 2000 born in Macau. Mandarin Chinese is the second-most-spoken language in Australia after English. Yet Chinese and other Asian Australians are underrepresented in professional and leadership positions — Australians of Asian ancestry comprise only 1.7 per cent of parliamentarians, 3 per cent of company executives and 3.8 per cent of public service leaders. The analysis at this point suggests there might be a 'bamboo ceiling' that needs to be broken if Australia is to call itself Asia-literate (Soutphommasane 2014).

There is also underdeveloped 'Australia-literacy' in China. Australia has its own institutional, legal, political, social and cultural system that has to be understood in order to be navigated by foreign commercial entities. While China's foreign linguistic capabilities and international trade integration are more extensive than Australia's, many Chinese entities are unfamiliar with how to do business in relation to Australia's democratic political system, regulatory, labour, environmental and economic policies, as well as its social norms and practices. This means that there are great opportunities for Australian financial, legal and business service-providers to work productively with Chinese enterprises trading and investing in Australia. Chinese business and government also need to recognise the benefit of investing at all levels in understanding unique Australian characteristics. For example, Australians' discomfort with the idea of a larger Chinese economic presence in Australia will be ameliorated by the efforts of Chinese investors that are Australia- and community-literate.

While individuals and even groups may invest in serious bicultural literacy, Australia and China cannot be expected to become productively literate in each other's society without high-level political advocacy and encouragement. The Comprehensive Strategic Partnership

for Change should create a properly resourced bi-national commission that would, among its larger goals, assist in promoting institutional exchanges across schooling, university, business and government that are linked to a strategic agenda for incentivising improvements to bicultural literacy and business capabilities.

These perceptions are revealed in various measures of distance between the countries and in polling data that suggest how close countries feel towards each other. These data reveal variations over time, but they show that Australians have a high degree of respect for China's achievements and status, and that Chinese have a warm regard for Australia's openness and role in the region. Despite system differences, Australia and China have a history of high-level, strategic cooperation and outstanding achievement in policy cooperation, from the early opening of the resource trade through to China's accession to the WTO, the recent negotiation of ChAFTA and their close cooperation in G20 affairs.

BOX 6.9: REGIONAL SECURITY AND THE AUSTRALIA–CHINA RELATIONSHIP

Both countries have a core interest in a secure region that provides a stable foundation for advancing international commerce and increasing prosperity. Both countries recognise the need for the regional order to continue to adapt and evolve to ensure this, in a way that respects and upholds the security and influence of all countries in the region.

Australia has relied on the United States for its defence since the wartime agreements of 1942 and has maintained a formal military alliance with the United States since the Australia, New Zealand and United States Security Treaty (ANZUS) was signed in 1951. The military alliance between Australia and the United States includes a mutual security commitment. It also includes intelligence sharing arrangements. There has been a longstanding, bipartisan commitment in Australian politics to this arrangement, it has wide public support and it is unlikely to change. This alliance relationship does not preclude cooperation with China in areas of shared interest.

While political and security relations can sometimes cut across economic interests, the foundation of a Comprehensive Strategic Partnership for Change is the long-term national interests of both countries. A current security issue of prominence in the region is conflicting territorial claims made in the South China Sea and the East China Sea. This Report has no role in weighing up these claims or their resolution, but it is in the shared economic interests of all parties to see the settlement of any disputes amicably and to ensure that the region remains open to trade.

In tandem with the technical advances and development of China's economy, its People's Liberation Army (PLA) has invested in a program of military development and modernisation. Recent investments in aircraft carriers, submarines, long-range missiles and an emerging 'blue water' navy have increased China's capabilities and ability to influence the region and beyond. Even in the context of a 'peaceful rise', it is to be expected that China will take steps to protect its own access to global trade, and to contribute to the security of its citizens and investments abroad.

China's emergence as a regional military power creates a potential strategic rival for the United States in the region. Under certain contingencies involving military conflict, Australia's alliance commitments might be invoked. Australia has already increased the number of

US forces rotating through Australia as part of the American 'Rebalance to Asia' strategy. The Australian government believes that 'any disruption to key regional sea-lanes and to Australia's ability to trade would have a fundamental impact on our nation' (Hurley 2014).

But Australia's alliance with the United States does not preclude security cooperation with China. Australia has the closest defence relationship with China of any of the United States' English-speaking allies. In December 2015, Australia hosted the 18th round of the official Australia–China Defence Strategic Dialogue in Canberra. This remarkable record of dialogue on military matters is a key asset for navigating not only bilateral defence relations but also, potentially, the future of regional security.

Regular bilateral exchanges take place between the Australian Defence Force and the PLA, including high-level officer visits, naval ship visits, strategic policy forums, humanitarian relief drills, cultural exchanges and an overarching Australia–China Defence Engagement Plan. In July 2014, PLA Navy vessels operated under Australian command during US-led 'Rim of the Pacific' naval drills, and Australia hosts an annual US–China–Australia trilateral military exercise in Northern Australia called Exercise Kowari. The Australian government is committed to continuing the development of its defence relations with China. Australia and China could demonstrate their respective commitments to transparent regional security cooperation by strengthening bilateral integration of their global peacekeeping and disaster relief forces.

Australia and China can build on this foundation of cooperation by working with other regional countries in existing forums like the ASEAN Defence Ministers' Meeting Plus and the East Asian Summit as well as in new multilateral policy dialogues on regional security issues.

The Comprehensive Strategic Partnership for Change recognises that regional politics are undergoing enormous change. This change needs to occur in a peaceful and progressive manner where no one country dominates another, and all states, large and small, are able to express their views and contribute to common security objectives. Australia and China can play vital roles in leading regional dialogue and brokering security, with their partnership as a vehicle for promoting regional security initiatives (Australian Centre on China in the World 2015).

Managing uncertainties

Learning how to make the Australian and Chinese systems work together in the process of enormous change and reform is crucial to the vitality of the Australia–China relationship. The different natures of the Australian and Chinese systems impact on economic uncertainty and risk directly; they play into how the two countries conduct their political and diplomatic relations, and these affairs ultimately affect the depth of their economic relations (Box 6.9). The principles and understandings that both countries articulate, and are guided by, in managing these differences have been, and remain, central to the success of their relationship. That is why the development of their Comprehensive Strategic Partnership for Change is important as the overarching framework for the relationship.

Change in the political and global order highlights the special importance of clarity in each country's approach to regional security affairs. (This issue is discussed in detail in Chapter 7.) Australia's alliance relationship with the United States and China's understanding of that

relationship provides a foundation for their own pursuit of closer bilateral security and military exchanges. Giving priority to the development of these ties across a wider range of traditional and non-traditional areas of security must be an active part of the agenda of the Comprehensive Strategic Partnership for Change and will serve indirectly to reduce economic risk.

More importantly, the foundations of trust (Box 6.10) that Australia and China already bring to their economic relationship, provides a base for them to work with their partners in the region, such as Japan, the ASEAN countries, South Korea and India to take initiatives towards addressing issues of common concern that have the potential to contribute significantly to enhancing regional economic and political security (see Chapter 7).

BOX 6.10: BUILDING POLICY TRUST

The elevation of the Australia–China bilateral relationship to a Comprehensive Strategic Partnership for Change requires a high level of trust between the two governments. The Partnership provides a base for expanding common ground for cooperation at the same time as managing risks, including policy and system difference risks. The foundations of a high level of trust reside with officials of both countries — in their professional capabilities, their in-depth knowledge of each other’s systems and their being culturally savvy. These capabilities and familiarities are essential to good judgment about policy intention, confidence in engagement and avoiding inadvertently harmful actions.

Australia and China have already come a long way in laying the foundation for confident high-level government-to-government engagement, with many steps already taken by both governments and central economic agencies in establishing strong institutional and official-to-official links. One example is the relationship between the Australian Treasury and China’s NDRC. Australia’s was the first Treasury of a Western country to set up an office within their Beijing Embassy, in 1993. The Australian Treasurer and the NDRC Chairman signed a MoU in 2008, which provided the institutional framework to guide the development of the agency-to-agency relationship in following years. The NDRC Chairman and the Treasurer have since met annually at Macroeconomic Dialogues to discuss global developments as well as macroeconomic policies and reform challenges in each country. Officials of the two agencies have paid frequent visits and engaged on a range of macroeconomic and structural reform policy issues of direct relevance to the policy agendas in China and Australia. The Australian Treasury has organised an annual seminar series conducted by Treasury officials in China, directed to developing an understanding of Australia’s economy and of Australian social and economic policy that is of relevance to China’s reform policies.

Recognising the importance of China to Australia’s prosperity as well as the complex and dynamic change taking place in the Australian economy, Australia’s central economic agencies, including the Australian Treasury, the RBA, PM&C and DFAT, have invested in developing skills and capacity for better understanding the Chinese economy and developing a more effective policy engagement with China. A strong motivation for this endeavour is that improved China knowledge, skills and capacity will enhance China policy and the benefits from the relationship for both countries.

These beginnings provide the foundation for the engagement that will be needed to manage and develop a more sophisticated relationship over the coming decade. The proposed Australia–China (Ao–Zhong) Commission, through its promotion of high-level exchanges, can assist in this. Existing institutional links demonstrate, however, that central economic agencies in both countries can profitably expand their ties. This Report, which has enjoyed the blessing of both the Australian and Chinese governments, is an example of effective working cooperation at the highest level between the two countries. The commitment by the Australian Treasury to support a follow-up project, to enhance Australian understanding of China’s economic policy and engagement with Chinese policymakers, is a further useful step in this direction.

Policy and institutional innovation

In all these areas, there is need for innovation in institutional mechanisms that will facilitate familiarity and understanding of motivations and intentions at the highest levels of policymaking, cooperation at the working level in policy development between governments, and investment in the human capital and collaborative policy infrastructure on both sides.

There is a broad and vast array of exchanges that occur within the Australia–China relationship. They span academia, the arts, business, culture, defence, economics, politics, science and security. Strengthening and encouraging these exchanges will be vital to success with the relationship in the coming decades.

The Comprehensive Strategic Partnership for Change can provide an overarching framework for long-term, high-level engagement that brings the countries closer by working together to advance articulated strategic objectives across all aspects of the relationship. It would enable the Australia–China relationship to become a model of how countries with different political and social systems and at different levels of development can collaborate to enhance collective welfare. Progress with deepening the Comprehensive Strategic Partnership for Change would build stronger holistic networks between the Australian and Chinese systems, rather than only disparate sectors, and this will in turn forge bilateral partnerships directed at realising particular opportunities and managing specific risks.

The future of the Australia–China relationship is best guaranteed through strong institutional arrangements and through an entrenched culture of cooperation between the two countries. The Australian and Chinese leaderships can encourage and promote a range of official, political, business and community initiatives in both countries to define and fulfil the potential of an enhanced Comprehensive Strategic Partnership for Change.

The Australia–China Comprehensive Strategic Partnership for Change would:

- underline both countries’ commitment to mutual trust;
- institutionalise their dialogues on strategic objectives and work programs on economic reforms and policy change;
- build bi-national capacity to support the new economic engagement; and
- lay the basis for deeper political cooperation.

The Partnership will entrench deeper and broader dialogues and cooperation across the relevant ministries and departments. It will be served by joint working groups on reform drawn from the national government, state and provincial officials, business, the military, research leaders, academia and the broader community. It will foster joint training and the development of long-term working associations in key areas between the officials of both countries. It will develop joint protocols for working together on bilateral, regional and global concerns.

Australia–China (Ao–Zhong) Commission

Beyond high-level official and semi-official exchanges, a major bi-national effort to upgrade the breadth and depth of exchanges is needed to support the development of the Comprehensive Strategic Partnership for Change. This effort needs to match the character and depth of exchanges that Australia has with other major partners, such as the United States. A model, on which Australia and China could build and extend, is the Australian–American Fulbright Commission, which is a non-profit organisation that was founded by a treaty between Australia and the United States. Core funding of a new Australia–China (Ao–Zhong) Commission should come from both national governments equally. But the Commission should also be open to approving and managing programs sponsored by state government agencies, business, academic institutions and personal bequests, as well as by both national governments. The Commission would be independently governed by persons of standing in both communities and protect the development of exchanges against particular influence or favour (Drysedale and Zhang 2016).

The Fulbright Commission coordinates educational partnerships and funds academic scholarships with a focus on developing ‘long-lasting, productive bilateral relations, partnerships and connections between Australia and the US’ (Australian–American Fulbright Commission 2016). However, a truly comprehensive and strategic Australia–China collaboration framework would extend beyond educational cooperation by also advancing and finding synergies between political, official, subnational, business and cultural exchanges and partnerships.

The Commission would further mutual understanding through educational and cultural exchange between the two countries. A crucial part of this program will be the development of deep networks between Australian and Chinese people across all areas of the relationship through the pooling of significant private resources into a public framework. Its importance could be symbolised by the two heads of government serving as dual honorary patrons. It would have three main purposes.

First, the Commission would foster high-quality research and academic exchange. The goal of this cooperation would be to increase the bi-national human capital across Australian and Chinese society, which will create deeper pools of talent from which to drive the bilateral relationship. Apart from scientific and research exchange, the Commission could support leadership in creating collaborative excellence in language and cultural education in primary, secondary and tertiary education systems through improved funding models, curriculum design, teacher training and attitudinal change. This would build into a version of the Australian–American Fulbright Commissions’ model of public and privately sponsored postgraduate, postdoctoral, early-career researcher and senior academic exchanges, with a focus on building long-term partnerships for research, mentorship, scientific innovation and entrepreneurial commercialisation. The Commission would also leverage existing official

initiatives such as Australia's New Colombo Plan and the Chinese Government Scholarships, and private initiatives such as the BHP Billiton Australia–China Scholarships and the Westpac Asian Exchange Scholarships.

Second, the Commission would foster policy exchanges. The goal of this cooperation would be to produce a cadre of political and government leaders in both countries who are familiar with the policymaking dynamics of the other country and have deep personal networks with their bilateral counterparts. There is positive experience with this through the programs that currently facilitate exchanges with China's Organisation Department through the Australia and New Zealand School of Government, and through the ANU's exchanges with the Central Party School. The deeper policy linkages that would result will sustain greater dialogue and more productive bilateral initiatives. The Commission can build on existing programs such as the National Parliamentary Fellowships Program and the National Government Fellowships to facilitate an extensive program of professional secondments and research fellowships for Australian and Chinese public servants and policymakers to either receive training in the regulatory workings of the other system or to work on targeted bilateral priority issues within the elite policy-shaping institutions and with the policy thought leaders of the other country. This would form a bilateral bridgehead between policymaking institutions and intellectual communities.

Third, the Commission would foster business and economic exchange. The goal of this cooperation would be to propel strategic collaboration on economic reform priorities that will help Australia and China to manage their respective transformations. This will be supported by the forward work agenda of this Report to undertake a comprehensive analysis of Australia and China's economic policymaking structures across all sectors and investigate how Australia and China should therefore best relate to each other across business, government and society. This project will be collaborative and serve to underpin Australian and Chinese economic engagement for the next decade. This research will become the platform for establishing the Commission and collaboration on similar institutions in different countries.

Across all of these sectors, the Commission would serve as an overarching framework that allows public and private actors in Australia and China to invest their resources in creating large-scale national programs of exchange for building talent in the pursuit of specific or general bi-national outcomes.

The Commission and the overall Comprehensive Strategic Partnership for Change are initiatives on which joint work can begin immediately for timely implementation by both sides. The process of planning, negotiating, launching and administering these arrangements, and the productive bilateral engagements and changes that they achieve, will lay the groundwork for Australia and China to upgrade their 'model' relationship over the longer-term into a bilateral treaty framework. This framework will cement political commitment to the relationship, institutionalise bilateral cooperation and perpetuate economic reform partnerships.

The common theme of bilateral collaboration across all sectors should be working together on joint initiatives with specific objectives and purposes towards outcomes that are a priority to both sides. Mobilised through the joint commitment of both governments, an expanding network of collaboration will constitute a truly strategic partnership for change. This partnership needs to be founded on deeper policy collaboration at all levels in developing the new bilateral relationship, defining joint interests in the regional economy, and strengthening the global economic system on the basis of inclusion and consensus.

This text is taken from *Partnership for Change: Australia–China Joint Economic Report*, by East Asian Bureau of Economic Research and China Center for International Economic Exchanges, published 2016 by ANU Press, The Australian National University, Canberra, Australia.