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Is There a Real Threat to Australia's National Security Posed by Sovereign Wealth Funds?

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Introduction

Sovereign Wealth Funds (SWFs) have existed since the 1950s.[i] However, the size, quantity, and reach of SWFs have increased dramatically over the past 15 years. In 1990 sovereign funds held at most $500 billion, the current total of SWF investments is an estimated US$4.3 trillion[ii], compared to a current global stock market capitalization of US$51 trillion[iii]. SWFs are expected to grow to US$12 trillion by 2015[iv], and are likely to be an enduring feature of global finance and geo-politics. Currently, more than 20 countries have SWFs, and half a dozen more have expressed an interest in establishing such a fund. The holdings remain quite concentrated, with the top five funds accounting for about 70 percent of total assets.[v] Over half of these assets are in the hands of countries that export significant amounts of oil and gas. In the case of China[1] and Singapore, these nations do not export oil or gas, but maintain massive trade surpluses from the export of manufactured goods. The top ten owners of SWFs listed in order of the size of funds include The United Arab Emirates (UAE), Norway, Singapore, Saudi Arabia, Kuwait, China, Libya, Qatar, Algeria, and the United States State (Alaska Permanent Fund Corporation).[vi] Many of these countries are not democracies, have unclear national strategic interests, and are not allies of Australia.

About one-third of the total assets of SWFs are invested in Asian and Pacific countries, including Australia.[vii] Investment in Australia has mainly come from China, Singapore, Dubai, Kuwait, and France and has been focused in energy, resources, infrastructure, utilities, and defense sectors. The risk raised by recent literature is that foreign ownership in such sectors may

[1]The term SOE, is used interchangeably with the terms government owned corporation, or government business enterprise. SOEs are most common in welfare-state nations, and socialist and communist nations. The difference between a SWF and an SOE is that a SWF is a foreign government owned investment fund that buys a share of an existing company, while a SOE is an existing foreign company that is owned by the foreign government. The Government of the Peoples Republic of China (PRC) for example, retains approximately 60% ownership of Chinese companies. Many Chinese SOEs operate outside of China, including inside of Australia. While SWFs and SOEs are different, foreign SOEs do operate inside Australia and as such, the actions and therefore the threats associated with SWFs can be extended to foreign SOEs. Thus, both SWFs and foreign SOEs should be considered together, as both SWFs and foreign SOEs that operate in Australia give a foreign government control of part of Australian industry; to ignore SOEs would ignore the true extent of foreign government ownership in Australia. As such, SWFs and SOE will be considered together for the purpose of this paper.

threaten national security. This paper investigates if SWFs pose a direct threat to Australia's national security or an indirect threat through its immediate area of interest (the Asia Pacific region).

Analysis Framework

Threats related to foreign government influence in domestic industries can be grouped into four general categories that provide a suitable framework for assessing the threat posed by SWFs to Australia's national security.

1) Influence of company and industry activity towards the strategic interests of the investing nations.
2) Access to sensitive technologies and threats to defense industry.
3) Geo-political influence and leverage over the country receiving investment.
4) Ideological concern, over the cross-border nationalization of industries in capitalist nations by communist and authoritarian regimes, and the shift in the free market paradigm.

Within this threat category framework, the components of economic security that Australia must protect are investigated and applied utilizing Christopher Dent's[2] components of economic security: supply security, market access security, finance-credit security, techno-industrial access security, socio-economic paradigm security, trans-border community security, systemic security, and alliance security.

Foreign Influence of Australian Company and Industry Activity

The leader of SWF investment in Australia is China. The Australian government has been concerned that the Chinese Government is gaining too much influence over resource industry operations in Australia. On 4 July 2008, the Australian Treasurer stated that since he took the position in November 2007, he had approved AU$30 billion in Chinese Government investment in Australia, at a rate of approval of one application every nine days.[viii] Chinese investment in Australia has grown from AU$3.7 billion in 2006, to AU$10 billion in 2007, and for 2008 is already in excess of AU$30 billion. This gives the Chinese Government five percent of all foreign investment in Australia (including both government and non-government foreign investment).[ix] Its investment interests are overwhelmingly in the energy and resource sectors.

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[2] In his book *Contemporary Security Studies*, Christopher Dent identifies eight components (what he calls "objective typologies") of economic security: "supply security, market access security, finance-credit security, techno-industrial access security, socio-economic paradigm security, trans-border community security, systemic security, and alliance security." These eight components refer to what a nation requires to engage in international trade and commerce in the modern age, while safeguarding the economic prosperity of its citizens. In addition, this work distinguishes the 'economics-security nexus', that is, the requirement for a nation to maintain a strong economy in order to fund and build military capability, and economic choices made to pursue the nation's strategic interests. This categorization of the components of economic security provides a valuable checklist for understanding the aspects of a nation's economy that must be safeguarded from external threats--including the threats of SWFs. The eight components of economic security identified by Dent will be applied within the four threat categories as part of the analysis.

The protection of a nation's energy reserves and energy industry has emerged as a top national security concern of many nations including Australia. Australia is the world's largest exporter of coal, has 40% of the world's low cost uranium reserves, and is the fifth largest exporter of liquefied natural gas, overall ranking Australia as the ninth largest energy producer in the world.[x] Australia exports 56.4% of its oil and petroleum production and imports 75.8%, meaning that, oil production could supply over 80% of its oil needs.[xi] As recently as 2003, Australia enjoyed a trade surplus in oil and refined products.[xii] Geoscience Australia predicts that Australia's net oil self-sufficiency will decrease from the current 80% to 20% over the next twenty years. The Australian Bureau of Agriculture and Resource Economics is more optimistic, predicting a decline of 50% over the same period.[xiii] Either way, oil is a non-renewable resource, giving too much control of Australia oil reserves to a foreign government may result in the depletion of Australian oil more quickly than Australian policy makers would otherwise choose, and before alternate energy supplies are readily available.

Australian reserves of Uranium and liquefied natural gas are more plentiful than oil, and global demand for them is increasing. Japan, India, China, Indonesia, the United States, and several European countries have each signaled their intention to build new nuclear power plants in the coming decade. The International Atomic Energy Agency estimates that nuclear power will rise from the current level of 16% of world electrical supply to 27% by 2030.[xiv] The shift towards nuclear power and natural gas is likely to increase Australia's energy exports. At today's production rates, Australia has 110 years worth of natural gas, and continues to find new gas fields. Australian energy currently accounts for 20% of export revenue and is increasing.[xv] SWFs have begun to invest in both Australian natural gas and uranium.

In a speech made on 5 June 2008, the Australian Minister for Resources and Energy, the Honorable Martin Ferguson stated, "energy security is one of the big issues confronting Australia and the world, for whoever controls access to energy resources controls economic growth." Amongst his list of threats to energy and resource security, the Minister mentioned "resource nationalization, unprecedented global growth and a scramble for resources, and the fundamental desire for nations to protect their own economic future." The minister stated, "the world is retreating from the open markets and free trade that we have worked so hard to achieve since World War II" and that "Australia does not have an energy security plan,…we need one." It is suggested that the energy and resource plan, that the minister identifies Australia requires, take into account SWF investment in this sector of Australian industry. In particular, Chinese interests in the Australian energy and resource sector must be assessed.

In an article titled "Global Maneuvers in the Mining Sector," of 7 February 2008, George Freidman observed:

> *Beijing has no qualms about throwing state funds into acquiring energy assets, even at a loss, because of the political rather than economic cost benefit analysis it uses, ... China wants control over what it considers strategic resources – energy reserves, minerals and metals that feeds it industrial growth.* [xvi]

Freidman explains, China seeks minimal reliance on free market imports and pursues ownership

of foreign companies, to ensure self-sufficiency as a matter of national security. He claims this is required due to PRC Government's grip over China's internal political and social stability depending on continued economic growth, for which stable energy and industrial supplies are essential. Buying up controlling ownership in resources assets in Australia and elsewhere reduces the risk of foreign companies or governments reneging on contracts and crimping parts of China's supply chain.[xvii]

As owners of Australian companies via SWFs, foreign governments gain shareholder voting rights and the ability to appointment directors to company boards, in this way they can influence company activities towards the strategic interests of the Chinese Government. Investigation identifies that the Singapore Government owns the bulk of electrical utilities in the Australian State of Victoria; while, the Dubai Government owns operations at Australia's five largest ports. A comparison to other nations found that the United States, New Zealand and Japan have chosen to reject applications for similar levels of foreign ownership in similar industries on national security grounds. An assessment of the capacity for Singapore or Dubai to influence the strategic decisions of the Australian Government finds that in the event of hostilities between one of these nations and Australia, each nation has some capacity to influence the Australian Government. However, due to the limited means to exercise influence and the current positive relations between nations it is assessed that this ownership does not pose a significant threat to Australia.

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The interests of the foreign governments that are within the capacity of SWFs to influence include: setting the rates of production (production rates that could be contrary to more sustainable development quotes envisioned by Australian policy makers); choosing the customer receiving Australian energy (i.e. Chinese markets and not Australian markets or customers that a free market would decide); and the setting of prices (it is possible that a foreign government could subsidize the company, thereby selling at a financial loss, avoiding payment of otherwise higher company taxes to the Australia Government, but also lowering price of commodities for other Australian producers).

An example of the extent of Chinese influence in the Australian resource industry is the iron ore rich Midwest region of Western Australia. A Chinese Government SWF consortium owns 100% of Midwest Iron (an iron ore company), has applied for 49% of Murchison Metals (also in the Midwest region), and is in the process of acquiring a 87.5% stake in Yilgarn Port and Rail project in the Midwest region, this would provide the Chinese Government complete vertical ownership of iron ore production. That is ownership of the mine, rail and port operations of the

Midwest region, and a region of Australia that is second only to the Pilbara region of Western Australia in iron ore reserves. This gives the Chinese-owned operation immense flexibility to set prices, production and markets, and to conduct cost and price transfer along the vertically owned production process to avoid Australian taxation and to destabilize the price of Australian iron ore.[xviii]

Another, much publicized issue has been Chinese SOE Chinalco's investment in 9% of resource giant Rio Tinto for $15 billion, with the apparent aim of blocking the takeover of Rio Tinto by BHP.[xix] The Chinese are opposed to the takeover. The companies would control around half of global metallic resources, this monopoly power is likely to raise global prices for metals, and compete with Chinese aims of securing access to resources. The decision on the Rio-BHP takeover is still pending but with 9%, control of Rio is voting shares the Chinese Government have a strong influence on the outcome. It is considered the action that prompted the Australian Treasurer's release of the six *Principles Guiding Consideration of Foreign Government Related Investment in Australia*.

In 2007, iron ore accounted for 7.5% of Australian exports, and is likely to increase due to infrastructure investment increasing the capacity of mining operations and the 85% increase in the contract price for iron ore that occurred in early 2008.[xx] Other mineral resources together account for 26.5% of exports, adding energy resources (coal, oil, natural gas and uranium) all resources account for 46.5% of Australian exports.[xxi] Maintaining control of Australian exports and limiting any negative effects from foreign government ownership is a challenge facing the Australian Government.

Access to Sensitive Technology and Protecting Defense Industry

Another threat presented by SWFs, is that a foreign government may gain access to sensitive technology and rights to protected intellectual property and transfer that knowledge back to the investing nation, or an adversary. This is of particular concern in respect to defense industry. Terrence Guay's 2007 U.S. Strategic Studies Institute-sponsored study provides relevant assessment, concluding that globalization has blurred the distinction between a domestic and foreign defense company. He finds that foreign ownership of the defense industry is a practical outcome of the globalization of capital, production, trade, technology, and labor. Guay claims that policies that aim to keep the artificial distinction, of domestic and foreign defense companies, are not helping the defense industry obtain the best technology, national security, or economic competitiveness.[xxii]

Turning to the Australian defense industry Australian Defence Industries (ADI), Australia's key defense contractor, was purchased by a partnership between Transfield (an Australian publically listed company) and Thales (a French publically listed company) in October 2007, to become Thales Australia. Thales Australia (formerly ADI), is Australia's largest defense contractor, employing 3,700 personnel across 35 Australian sites. [xxiii] Thales is a publically listed company on the Euornext stock exchange, the Thales website reveals however that the French public sector owns 38% of the voting stock of Thales International.[xxiv] Equipment manufactured by Thales Australia includes: the vast majority of Australian ammunition and explosive ordnance, the Australian standard issue rifle the F88 Austeyr, the Bushmaster protected mobility vehicle,

the ANZAC class Frigate, and several electronic warfare systems, to name a few.[xxv] As Thales international holds 50% of Thales Australia, this places approximately 19% of the voting stock of Thales Australia in the hands of the French public sector. The Australian Treasurer, following the recommendation of the Australian Foreign Investment Review Board (FIRB) in October 2007, approved the purchase of ADI by Thales.

Furthermore, a Senate inquiry was held after the sale, one of the objectives of the Senate inquiry was to investigate the impact on Australia's national security and defense industry. The Senate inquiry was satisfied with the procedures to safeguard Australian national security because of the sale of ADI to Thales.[xxvi]

It is evident that Australian policy makers and practitioners maintain tight regulation over the Australian defense industry. However, to some the fast turnaround of ADI from a 100% Australian SOE as recently as 1999, to 19% foreign government ownership in 2007, may sound like the small edge of the wedge. However, the conclusions from Terrence Guay's 2007 study, indicates that Australia must engage foreign capital and foreign expertise in order to obtain the best contractor support to its defense force. Guay's conclusion is sound and has direct application to Australia, Thales has enormous experience in developing technical systems for joint systems, and Australia has a lot to gain from engagement with Thales.

Geo-Political Leverage

A nation employing SWFs may gain increased geo-political influence and leverage over not just a company or an industry, but over the strategic decisions of a Government. At its extreme, in the event of hostilities, deliberate acts of economic sabotage may be used.

An investigation of Australia's utilities sector reveals considerable ownership by the Singapore government. The total of Singapore SWF investment in Australian utilities is approximately $12.9 Billion, across four electricity and gas providers. This includes monopoly ownership of electricity utilities in the state of Victoria, a substantial share of natural gas utilities in South Australia and Victoria, and ownership of the Basslink electrical cable linking Tasmania to the Victorian electrical grid. Singapore is an ally of Australia under the Five Power Defence Arrangements (FPDA), and Australia and Singapore enjoy a close trading relationship. However, this level of foreign government ownership provides control of electrical utilities for approximately 25% of Australia's population and businesses. Comparing a similar situation in New Zealand, in April 2008 the New Zealand government rejected a bid from the Canada Pension Plan Investment Board (CPPIB), to buy a 40% stake in Auckland airport,[xxvii] as well as a separate bid from a Hong Kong company to buy the main electrical utility supplier to the N.Z. capital city, both rejected on "national security grounds".[xxviii]

The Dubai Government owns facilities and stevedoring services at half of all Australian ports. In March 2006, Dubai Ports World, which is wholly owned by the Dubai Government, purchased 100% of Peninsular and Oriental Steam Navigation Company (P&O) of the United Kingdom. This made Dubai Ports World the four largest global port operator. This includes Australia's five largest ports (Ports: Adelaide, Brisbane, Fremantle, Melbourne and Botany), and control of all sea-borne import and export to Australia's five largest population centers (approximately 80% of

the Australian population and businesses). Initially the purchase included 22 ports in the United States, however, United States concerns in regards to border security and geo-political influence, led to a bill being passed in the U.S Senate to block the sale of U.S. ports. Dubai Ports World was forced to sell the U.S. ports to American International Group, but maintained ownership of the ports of other nations including Australia.

The United States decided that the Dubai Government's ownership of its ports was a national security threat, related to the potential to disrupt port operations and to interfere with border security.[xxix] The United States removed any potential threat from the Dubai Government, while that potential threat is still facing Australia. However, can the governments of Singapore and Dubai use this ownership to influence the strategic decisions of the Australian Government? Delving into how such geo-political influence may be exercised gets complicated and speculative. For a start there would have to be a disagreement between nations who, are allies in the case of Australia and Singapore, and who share friendly relations (including defense cooperation) in the case of Australia and Dubai. Second, the physical infrastructure (power supply, electricity grid, and ports) are in Australia, and the workers and management are essentially Australian. If operations of these industries were deliberately disrupted to apply political pressure, it is possible for Australia to seize the facilities and recommence the distribution of electricity, or the operation of the ports, albeit after a period of disruption.

Regarding border security concerns due to foreign ownership of ports, the workers and management at Australian ports remain essentially Australian. Furthermore, the laws and regulations in regards to port security are Australian laws, and Australian Customs and the Australian Quarantine and Inspection Service (AQIS) carry out inspections. As such, it is assessed that the foreign ownership of Australian ports by Dubai Ports Worlds has negligible impact of Australian port security.

An example of a nation exercising political leverage via the ownership of utilities is the Russian Governments influence over its neighbors because of its control of natural gas supply. The Russian SOE Gazprom provides 98% to 100% of the natural gas used by the Baltic States, Greece 82%, Turkey 65%, Germany 39%, and France 24%. A United States Report for Congress, in regards Russian control of natural gas supply to Europe, reported that "actual and threatened cut-offs have provoked criticism that Russia is using energy as a political tool."[xxx] In the case of Russian gas supply to Europe, the source of the gas is in Russia and pipelines out of Russia physically deliver the gas to Europe. Thus, it is possible for Russia to cut physically supply. This is somewhat different from the situation of Singapore and Dubai ownership of Australian electricity and ports; as in the Australian case all facilities are in Australia, making it more difficult to disrupt operations, and easier for Australia to restore operations. Nevertheless, the Singapore and Dubai governments gain potential for a small, speculative, and unquantifiable level of leverage over Australian Government strategic decisions in the event of hostilities. However, due to the limited means to exercise influence and the current positive relations between nations it is assessed that this ownership does not pose a significant threat to Australia.

Consideration must also be given to the effect that a foreign government can have if it sold a significant portion of its investments on the Australian stock market over a short period. The effect would include a drop in the stock price of the companies concerned. The selling of a large

amount of stock could result in the drop of that sector of the stock market, and this could be transferred to a drop in the overall Australian stock market. The selling of Australian currency to redeem the investment back into the currency of the investing nation could then lower the exchange rate of the Australian dollar. The United States uses such a tactic to cause economic distress and pressure the governments in the United Kingdom, France, and Israel during the 1956 Suez Crisis, by aggressively selling each respective currency. However, have any of the nations investing SWFs in Australia expressed an intention to use SWFs as a tool of economic warfare? The book *Unrestricted Warfare* (1999), authored by two Chinese Army Colonels; this book provides evidence that China is well advanced in understanding the wide array of national tools available in the age of global finance. *Unrestricted Warfare* discusses:

> *There is nothing in the world today that cannot become a weapon … as we see it, a single man-made stock market crash, a single computer virus invasion, or a single rumor or scandal that results in the fluctuation in the enemy countries exchange rates or espouses the leaders of an enemy country on the internet, all can be included in the ranks of new-weapon concepts ... The new concept of weapons will cause ordinary people and military men alike to be greatly astonished at the fact that commonplace things that are close to them can also become weapons with which to engage in war.*[xxxi]

This book provides a clear warning of the potential for SWFs to be used to exert geo-political influence. The selling of a large quantity of investments over a short period could cause a financial crisis. Such action is likely to cause also some initial economic disadvantage to the investing nation, as any remaining investments would fall in value, or other interdependent linkages harm the investing nation. However, an authoritarian nation is not directly responsible to its citizens and may choose to absorb the financial loss as the cost of war. Strategic decision-making may consider the cost, of economic damage to the investing nation, to be equal to or less than the losses expected during the waging of a conventional war.[xxxii]

The potential for Singapore, China, or Dubai to mount financial attack against Australia appears very remote considering that the nations currently enjoy a mutually beneficial trade and investment relationship. However, mutually beneficial trade and friendly relations existed between the United States and the United Kingdom, France and Israel when financial coercion was used during the 1956 Suez Crisis. Thus, it must be acknowledged that SWFs do provide the investing nation with the potential to use financial coercion via the rapid selling of SWF assets.

To address quickly a few remote possibilities, the majority of the nations holding SWFs are authoritarian, what would happen to the investments if a revolt led to a change of government within a nation holding SWFs? Could a new rebel faction have a desire quickly cash-in an investment triggering economic pain for Australia? On the other hand, if one or more nations combined (think of possible Chinese/Taiwan reintegration) would the combined entity control an undesirably large amount of Australian industry? These possibilities are obviously speculative and will not be further investigated, however, it must be remembered that the international landscape of national borders is forever changing.

Ideological Concern

SWFs have raised concern for ideological reasons, as SWF investment equates to the cross-border nationalization of industries in capitalist nations by communist and authoritarian regimes. SWF investment is a change from the privatization of industries that has occurred in most of the western world throughout the 1970s and 1980s, back to nationalization of industries; however, under SWFs the nationalization moving across national borders from a foreign government. This challenges the economic security components 'socio-economic paradigm' and 'systemic security' identified by Christopher Dent. Australia and other western nations have chosen a system of free markets, or at least mixed markets, and minimal government ownership (to varying degrees depending upon the country involved and the political party in the majority). Experience over the last 30 years has suggested that a system of majority-privatized industry is efficient in allocating jobs, and delivering goods and services. The current Australian economic paradigm, of market liberal capitalism, is starting to be challenged by SWFs. Observers inclined to a preference for a political-economic system of increased government ownership would also be concerned for the shift in paradigm if the government exercising control was not its own.

The Singapore and Chinese Governments each control more business assets in Australia than the Australian Federal Government.[xxxiii] Many SWFs are aiming to participate in free markets solely in the pursuit of profit. However, there is potential for SWFs to affect the current economic paradigm of free markets. The concern of Chinese nationalization of the Australian resource and energy industries in order to control access to raw materials and energy has already been illustrated. SWFs have the potential to buy up competitor companies and to obtain vertical ownership of the production process, they can influence the markets to which they sell, prices, and rates of production, and affect the principles of free market competition. Such actions are perfectly logical for the SWF concerned from a commercial perspective, however, could be problematic from the perspective of policy makers concerned about the scale of foreign government influence in the Australian economy. The effectiveness of Australian foreign investment policies to mitigate the threats of SWFs is outlined below.

Mitigation

Australian National Strategic Policy Documents

National strategic policy documents of Australia are yet to address the specific threat of SWFs; however, policy documents do refer more broadly to the threats of economic power and the increasing financial wealth of emerging countries. *Australia's Foreign Policy and Trade White Paper 2003,*[xxxiv] the *Department of Defence White Paper 2000,*[xxxv] and *Australia's National Security: A Defence Update 2007,*[xxxvi] do not refer to the threats of SWFs; however, they do recognize that "globalization is a trend shaping the strategic environment."[xxxvii] *The White Paper* recognizes that, "Australian industry is a vital component of Defense capability, both through its direct contribution to the development and acquisition of new capabilities and through its role in the national support base." [xxxviii] The importance of Australia's defense industrial base to national security is echoed again in *The Defence Capability Plan: Public Version 2006-2016; The Defence and Industry Policy Statement 2007* and *The Defence Procurement Review 2003.* These documents identify that Australian industry is of national strategic importance.

Australian Foreign Investment Policy

The Australian government has demonstrated awareness of the emergence of SWFs. In a statement directed to the governments behind SWFs, on 9 April 2008 while attending a meeting in Beijing, Australian Prime Minister Kevin Rudd stated:

> *[As Prime Minister, I will] defend the Australian national interest and the Australian national economic interest, and I make no apologies for that… Australia is an open market when it comes to foreign investment and we have a history of depending on foreign investment… We have always had proper regulations to examine and advise on projects of consequence.*

On 17 February 2008, Australia became the first country to release a set of guidelines that apply to all investments by foreign governments. The *Principles Guiding Consideration of Foreign Government Related Investment in Australia,*[xxxix] released by the Australian Treasurer, outline six principles that proposed investment by foreign government entities will be measured. The principles build on the existing framework of Australia foreign investment policy and the *Foreign Acquisitions and Takeovers Act 1975,* and the *Foreign Acquisition and Takeovers regulations 1989.* Under the policies, certain investments must be notified to the Treasurer and the Treasurer may prohibit investments that are deemed to be contrary to Australia's "national interest." The term national interest is not defined in either the policy or the Act, meaning the Treasurer enjoys considerable discretion in exercising this power.

The policy distinguishes between investments by private entities and foreign governments. Foreign Direct Investments (FDI), defined as an investment of 10% or more, of an Australian company by a foreign government must be reported to and approved by the Treasurer. This includes any entity with 15% or more foreign government ownership. Portfolio investment (less that 10% ownership of a company), is regarded as having the primary purpose of investing for profit rather than for gaining influence over company strategic direction; portfolio investment does not require approval by the Treasurer.[xl]

The Australian Treasurer's six principles include:

1) An assessment of whether the investor's operations are independent from the relevant government.
2) Whether the investor is subject to or adheres to the law and observes common standards of business behavior.
3) Impact on competition.
4) Impact of government revenue.
5) Impact on national security.
6) Impact on the operations and directions of an Australian Business.

These new principles reflect the recent concern voiced by the IMF about the transparency of SWFs. The treasurer has also sought to reassure investors that Australia remains welcoming of foreign investment. Arguably, this addresses the IMF's other concern that a reaction against

SWFs may trigger protectionist actions that would be an obstacle to the maintenance of a free trade and free investment environment.[xli]

The Foreign Investment Review Board (FIRB) assists the Treasurer in making his determination. In addition to the Australian foreign investment policy and the Act, and the new principles there is existing legislation related to foreign investment in prescribes sensitive industries, including: Media; telecommunications; transport; training and human services; defense industry and defense technology; uranium, plutonium and nuclear. On the 24 June 2008, a background note was prepared for the Members and Senators of the Australian Parliament providing a summary of the responsibilities and powers of the FIRB regarding the takeovers of Australian companies by overseas companies. The note also covers the emerging issues associated with SWFs.[xlii]

The Australian policy outlined above provides the Australian Treasurer with considerable discretion in determining what constitutes the national interest, following investigation and recommendation by the FIRB. The existing policy supplemented by the new principles provides strong mitigation against the threats associated with SWF. The release of the principles provides reassurance that Australian policy makers are aware of the threats and opportunities associated with SWF, and furthermore, that they are prepared to intervene when needed to protect the national interest. The intent of the new six principles is to highlight the need for transparency and regulation of SWF investment. While, conscious of the threats, the statements released by the Australian Government acknowledge that once regulated SWF investment offers significant benefits to the Australian economy.

The Treasurer's new principles and the *Foreign Takeovers Acts* provide evidence of the Australian governments concern for the protection of national industries from foreign government ownership. Australia was the first nation to release a set of principles in regards to SWF, since then Germany has released a policy statement and several other nations have begun discussion regarding policy adjustments. The following mitigation analysis turns to the macroeconomic conditions underlying Australia's need to accept foreign investment in order to finance its current account deficit.

Macroeconomics: Australia's Current Account Deficit and the Need for Foreign Investment

As of the end of the June quarter 2008, Australia had a current account deficit of AU$12.7 billion (after reaching a record high deficit of AU$19.5 billion in March 2008).[xliii] A current account deficit can be financed in two ways, by increased borrowing from overseas or by increased equity investments by foreigners into Australia. If it were deemed that foreign investment was too high, it follows that one solution for stopping the need for foreign investments would be for Australians to save money and invest in Australia or to spend their money in Australia, rather than spend money on imported goods. However, it is not this simple, as it is hard for a nation with Australia's small population to produce the diversity of goods available in the world. Furthermore, many imported similar type goods are relatively cheap compared to goods made in Australia due to Australia's high standard of living and associated higher input costs.

What Australia has in abundance and can efficiently process is natural resources. Specifically,

iron ore, other metals, and coal needed by China to support its rapid development. To get the greatest benefit out of this situation, Australia must increase the capacity of its resource industry (including, the capacity of mining operations, railways, and ports). This increase in resource industry capacity needs investment capital. Foreign investment can therefore assist to finance the expansion of the Australian resource industry, increasing the quantity of Australian resources available for export and assist in reducing the current account deficit.

Australia's current account deficit (combined with that of other nations) is the underlying reason for the buildup of trade surpluses in the nations holding SWFs. These nations holding SWFs have the requirement to invest this money somewhere, and Australia has the need to receive foreign investment to finance its current account deficit. SWF investment in the Australian resource industry can recycle this surplus, assisting in financing Australia's current account deficit; but it can also, assist in expanding the amount of Australian, exports reducing the underlying deficit and thus reducing the buildup of SWFs. Increasing the export of Australian resources also provides profits to Australian companies, higher wages for labor, and tax revenue for the Australian government.

Following this line of thought and the apparent benefits to Australia, it would appear foolish for the Australian Government to refuse foreign government investment in its resource industry. However, the detail is very complicated and it appears that the Australian Treasurer is now carefully considering the long term affect of SWF investment in the resource industry. In addition to resource industry accounting for approximately 46.5% of Australian export earnings (and is growing), it employs eight percent of the Australian workforce.[xliv] Yet, only 20% of the Australian resource industry is owned by Australian investors.[xlv] Foreign private investors via multinational companies own the majority; but the level of Chinese Government ownership is growing and targeting specific sectors, giving China the potential to influence prices, production, and markets within certain sectors. The *National Strategic Plan for the Geosciences*, states "the Australian Government has recognized the need for sustainable management of the nation's natural environment and resources in order to continue to build wealth."[xlvi] Consideration includes that "over the next fifty years, it is estimated that the world will use five times the resources that it has mined to date."[xlvii]

SWF Indirect Threats to Australia: Influence in the Asia Pacific Region

SWF investment in developing nations in Australia's immediate region may continue to affect indirectly Australia's national interests. Developing nations are less likely to control foreign investment, as the legislative mechanisms of these nations are not sophisticated, and these nations are desperate to receive foreign investment funding to assist in overcoming endemic economic problems. [xlviii]

The People's Republic of China (PRC) and Taiwan both extended their diplomatic and commercial presence, including via the use of SWF investment in the Asia Pacific region, principally in order to garner political support in relation to the recognition of Taiwan. China is also pursuing access to fish stocks, and minerals; and possibly pursuing wider strategic influence in the region. Several analysts argue that this unconditional aid in exchange for support on diplomatic issues is unregulated and poorly managed, and may exacerbate corruption and

political instability in the recipient countries, while not leading to broader economic development.[xlix]

Fergus Hanson's June 2008 report for the Lowy Institute for International Policy states that China is now the third largest aid donor to the South Pacific after Australia and the United States. The report also notes that Beijing is just as ready to slash aid to nations that switch allegiance on the issue of recognition of the PRC over Taiwan.[l] Hanson's research finds that China does not release the value of its aid, but his research estimates that Chinese aid in the South Pacific grew from $33 million in 2005 to $293 million in 2007. While these figures represent foreign aid, Chinese Government SWFs are amongst the mix of funds.

Hanson warns that China's investments are undermining Australian and other Western donor's in the region. His report states that the opaque nature of China's aid and investment undermines other nations' efforts to improve transparency, accountability, corruption, governance, and stability.

Following the latest military coup in Fiji in 2006, Australia and other western donors were exerting pressure on the Fijian coup leaders to restore democracy, on the other hand the Chinese Government provided investment totaling $150 million, the largest Chinese aid package in Fiji so far. In 2006, a Taiwanese delegation is alleged to have offered a payment of US$30 million to Papua New Guinea (PNG) Government officials; the aim of the bribe was apparently PNG recognition of Taiwan. The $30 million dollars is missing, and the PNG Government claim to have no knowledge of the deal. The resulting scandal has seen the resignation of the Taiwanese Vice Premier and Foreign Minister, and the credibility of the PNG Government has been undermined.[li] Chinese and Taiwanese vote buying has also occurred in Timor Leste.[lii] Within the region Chinese investment is also found in mineral resources and timber principally in PNG, Fiji, and the Solomon Islands.[liii] Other investments from China and Taiwan consist of construction projects such as government buildings and sports stadiums in capital cities that directly benefit the government in power rather than addressing underlying social and economic problems. [liv]

Responsible and well-managed foreign investment can assist in the development of the Pacific; however, Hanson's study warns that Chinese and Taiwanese investment is not well managed. He outlines that the intentions of Chinese and Taiwanese government investment is largely benign, but he concludes the lack of regulation of foreign investment is likely to lead to corruption, and instability, by exacerbating underlying problems of corruption and political, economic and social instability.

Australia, New Zealand and the United States share mutual strategic interests of promoting economic development, political stability and controlling civil unrest in the Pacific region. Australia continues to provide the highest level of financial aid to the Pacific region.[lv] In addition to financial aid, Australian assistance includes law and order and governance support via the deployment of Australian Federal Police and government advisor teams. The Asia Pacific region has been referred to as Australia's "arc of instability." Many nations of the Asia Pacific have suffered from conflict in recent years and in several instances Australian military intervention has been required to restore order. In the last ten years, alone Australian military intervention

has occurred in Timor Leste 1999-2006, and 2006 to present), the Solomon Islands (2003-present), Fiji (2000, and 2006), Tonga (2006), and Papua New Guinea/Bougainville (1997-2003, and 2004). This regional instability threatens Australia due the associated attraction of transnational crime, people smuggling, drugs, refugees, and the possible harboring of terrorist cells by failed states. Efforts to prevent instability in the region expand Australian financial resources and use the time and energy of many Australian Government departments. In addition, the consistent deployment of Australian troops to this region has an opportunity cost, as the troops deployed are not available for other tasks including commitment to Australia's wider bilateral and multilateral strategic alliances.

International Steps to Mitigate Concern

Policy in relationship to SWFs is quickly evolving. Over the course of 2008, there has been rapid international progress to mitigate concerns in respect to SWFs. The international community with leadership by the G7, OECD, and the IMF is pushing for transparency and regulation of SWFs. The OECD and IMF joint conference, "Sovereign Wealth Funds in the Global Investment Landscape: Building Trust," of 31 March 2008, provided an opportunity for representatives of sovereign wealth funds (SWFs), private financial institutions and recipient governments to share views on what steps SWFs and recipient governments can take to build mutual confidence and trust. This meeting led to further discussion by the G7 during the first week of April 2008. The OECD, IMF, and G7 are principally concerned with maintaining free markets and avoiding protectionism.[lvi]

The concerns raised by the international community led to the rapid establishment of the "International Working Group of Sovereign Wealth Funds" which held its first meeting 30 April – 1 May 08, at the IMF Headquarters in Washington, DC. The International Working Group (IWG)[3] is co-chaired by a senior representative of the Abu Dhabi Investment Authority (ADIA) and the Director of the IMF's Monetary and Capital Markets Department who were selected by the participating SWFs. [lvii]

A significant milestone was reached by the IWG during second meeting held in Santiago, Chile on 20 September 2008. The working group drafted a set of voluntary "Generally Accepted Principles and Practices for the conduct for Sovereign Wealth Funds." These have become known as the 'Santiago Principles' and were subsequently presented at the 11 October 2008 meeting of the IMF. Twenty-four principles were identified for which there are four guiding objectives: 1) to help maintain a stable global financial system and free flow of capital and investment. 2) To comply with all applicable regulatory and disclosure requirements in countries in which SWFs invest. 3) To invest based on economic and financial risk and return-based considerations. 4) To have in place a transparent and sound governance structure that provides

[3]The IWG member countries are Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Iran, Ireland, South Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad and Tobago, the United Arab Emirates, and the United States. Saudi Arabia, Oman, Vietnam, the OECD, and the World Bank participate as observers. The aim of the IWG is to help maintain a stable global financial system, the free flow of capital and investment, and manage concerns of SWFs and the international community.

for adequate operational controls, risk management, and accountability. The Working Group also proposed to establish a standing group of SWFs that would keep the principles under review, monitor implementation, and continue dialogue with recipient countries.[lviii] The rapid creation of the IWG, its quick action to develop the Santiago Principles, and the membership of Australia, China, Singapore, and the UAE provides a solid sign of progress in regards to the management of the Australian and international concerns in regards to SWFs. While, the 'Santiago Principles' are voluntary this is a positive step toward responsible, transparent and regulated SWF activity, and reducing the threats while enjoying the benefits of SWFs. The 2008 global financial crisis has developed, during which in many cases SWFs entered as welcomed rescuers of troubled companies providing much needed financial capital.

Conclusions

SWFs offer both threats and opportunities to global finance and geo-politics. As such, SWFs present a dilemma as nations want to attract the benefits of foreign investment, while also safeguarding against the threats of foreign government influence. SWF investment in Australia has offered many benefits to Australia by recycling trade imbalances and providing investment capital for development of infrastructure in the energy and resource sectors.

Many SWFs are aiming to participate in free markets solely in the pursuit of profit. It appears that in the case of certain Chinese Government investments in the Australia resource industry that the intention of the Chinese Government is access to and control of resources, rather than investing only for profit. In situations where the Chinese Government holds controlling stakes of companies, and/or vertical ownership of production, it is possible for influence over production, markets, and prices. Such actions are perfectly logical for the SWF concerned from a commercial perspective however; this could be problematic from the perspective of Australian policy makers.

Much of this paper has focused on the Peoples Republic of China this is a logical result of it recently receiving significant media coverage in regards to its investment in the Australian resource industry. Nothing found in this research suggests that China is interested in anything other than a 'peaceful rise.' Furthermore, China's peaceful rise has offered significant benefits to Australian economic prosperity by the purchasing of Australian resources and by providing capital investment for Australian infrastructure development. This has led to increased mining, rail and port capacity, which has brought higher wages to many Australian workers, higher profits to many Australian companies, and increased mining royalties and taxes collected by the Australian government. In addition, trade with China has provided Australian consumers with competitively priced manufactured goods; the combined effect has been a higher standard of living for the majority of Australians. Australia and China continue to be solid partners each mutually benefiting from growth in both nations.

Australia must balance the requirement to maximize the benefits of foreign investment, while, safeguarding against too much foreign government influence. This must include maintaining favorable macroeconomic conditions to reduce Australia's current account deficit. Based upon Singapore and Dubai's SWF holdings in Australia, in the event of hostilities between one of these nations and Australia, each nation has some capacity to influence the Australian

Government. However, due to the limited means to exercise influence and the current positive relations between nations this ownership does not pose a significant threat to Australia.

Capital and technology in the defense industry is assessed as a practical outcome of globalization. Australia must engage foreign capital and foreign expertise in order to obtain the best contractor support to its defense force. This level of foreign ownership in the Australian defense industry is largely unavoidable and on balance offer considerable benefits to the development of Australia defense capability. Nevertheless, Australian policy makers should continue to monitor developments within the defense industry.

The release of the six *Principles Guiding Consideration of Foreign Government Related Investment in Australia*, by the Australian Treasurer in February 2008, provides reassurance that Australian policy makers are aware of the threats and opportunities associated with SWFs, and furthermore, that they are prepared to intervene when needed to protect the national interest. Australian policy provides the Treasurer with considerable discretion in determining what constitutes the national interest. Existing policy, supplemented by the six new principles provides strong mitigation against the threats associated with SWFs.

SWF investment in developing nations within Australia's immediate area of interest is likely to continue. These nations are less likely to have the regulatory mechanisms to control investment, and they are more desperate to receive investment funding to assist in overcoming endemic economic and social problems. Chinese and Taiwanese SWF activity in the Asia Pacific region has the potential to affect indirectly Australia's national interests. As unregulated and opaque SWFs, investment has the potential to lead to corruption and instability in the region; restoring stability may require Australian intervention. If delivered responsibly aid and investment from other nations has the potential to support Australian interests in the region. The voluntary 'Santiago principles' provide a positive step toward ensuring responsible, transparent and regulated SWF activity. Australian officials should use bilateral and multilateral forums to request compliance with the Santiago Principles.

Reference to threats to national security should be reserved for events that seriously undermine: territorial sovereignty, democratic freedoms, the rule of law, or fundamental economic prosperity.[lix] As Ungerer suggested, "non-traditional security risks only become a national security risk when they meet the benchmarks of scale, proximity, and urgency." Furthermore, what constitutes a threat "can be limited by the range and availability of resources to respond."[lx] At present SWFs, do not meet the definition of a threat to Australia's national security, a title that must be reserved for the most serious events. This does not mean that SWFs cannot evolve into a threat to national security. SWFs do continue to pose a significant challenge to policy makers, in particular for the Department of the Treasury and the FIRB (and overlapping into several other policy areas) as they adjudicate on appropriate levels of foreign ownership. However, at this time, the challenge posed by SWFs affects shades of economic prosperity, and challenges to peripheral regional security issues, rather than threats to Australia's national security.

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