Outbound investment

April 2017

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committee for economic development of australia

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About this publication
Outbound investment
© CEDA 2017
ISBN: 0 85801 312 6

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Design: Robyn Zwar Graphic Design

Photography:
Page 63: Glenn Campbell, Fairfax Image
Page 79: Geng guoqing, AAP Image
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CEDA – the Committee for Economic Development of Australia
Level 13, 440 Collins Street
Melbourne 3000 Australia
Telephone: +61 3 9662 3544
Email: info@ceda.com.au
Web: ceda.com.au

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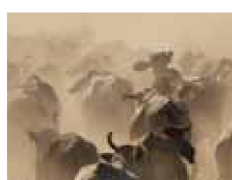

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Foreword

Australia's outbound investment and its economic benefits have received considerably less attention than inbound investment as the latter is often emotive and couched in concerns about "selling the farm" or national security.

However, outbound investment will be an increasingly important pillar in our economic growth.

This research focuses on foreign direct investment, where Australian companies are investing directly by building a plant or setting up a joint venture abroad – the stock of investment abroad currently amounts to more than A$500 billion per year.

The top three recipients of Australia's outbound investment are currently the United States (US), the United Kingdom (UK) and New Zealand.

With the rise of protectionism in at least two of these jurisdictions, it will be important for Australia's long-term economic sustainability that other markets are developed or enhanced.

Obviously, we are perfectly situated geographically to tap into two of the biggest and fastest-growing markets – China and India, which both have burgeoning middle classes demanding better and new products and services.

Yet while the amount that flows to China and India has been rising, it still only accounts for 2.9 per cent of Australia's total outbound investment.

CEDA has undertaken this research because despite some criticisms that outbound investment results in the offshoring of domestic jobs, the economic benefits are significant and numerous, ranging from:

- Increased exposure and access to new and growing international markets;
- Increased demand for Australian products and services;
- Integration into global value chains; and
- New job creation, both abroad and in Australia.

However, barriers and risks remain for Australian businesses, and increasing awareness and changing policy in key areas could improve outcomes.

Areas covered in this research include:

- The importance of ensuring new trade barriers are not put in place due to growing anti-globalisation sentiments, and that Australians understand the benefits locally of outbound investment for our economy;
- The Australian taxation system and specifically the dividend imputation system and its impact on outbound investment;
- Ensuring that Australian businesses doing business in Asia have a local presence and contacts;
- Options for promoting specific export industries;
- The importance of Austrade and the Export Finance and Insurance Corporation (EFIC) in continuing to promote Asia as a primary focus for outbound investment;
- Investment in chilled and fresh food distribution systems; and
- Utilising existing human capital in Asia in the form of Australian expatriates.

I would like to thank the contributing authors for their contribution to this important piece of research and the CEDA Advisory Group that helped shape this project.

As I have said, outbound investment does not receive the attention it should, given its growing importance to our economy.

I hope this research will help generate discussion on the importance of outbound investment and how we can help Australian businesses tap into global markets.

Professor the Hon. Stephen Martin
Chief Executive
CEDA

Executive summary

For 200 years Australia has used inbound foreign investment to develop its economic potential. However, as a mature economy, and with the end of the resources investment boom, business investment abroad will play an increasingly important role in the nation's economic growth. While there is considerable interest focused on inbound investment, particularly when it involves foreign investors in the agricultural sector or the housing market, Australia's investment abroad has received less attention.

Australia's investment abroad consists of foreign direct investment (FDI), portfolio investment and all other investments. FDI includes, for example, an Australian company investing directly by building a plant or setting up a joint venture abroad, whereas portfolio investment is done through the purchase of foreign equity or debt securities. Other investments include financial derivatives, reserve assets and all other investments.

FDI implies that the investor has the power to exert significant control that affects decisions in the offshore organisation. This research focuses on FDI, which is also referred to as outbound investment for the purposes of this report. Put simply, outbound investment is Australian firms investing in or setting up offshore businesses.

Australia's investment abroad amounted to A$2.1 trillion in 2015, a rise of eight per cent on the previous year. Outbound investment accounted for just over a quarter of this, or about A$542.6 billion.

Australia's outbound investment primarily flows to open, Western and English-speaking countries, with the top three recipients, the US, the UK and New Zealand accounting for close to half of the stock of FDI. By contrast, China and India together account for just 2.9 per cent of Australia's stock of outbound investment, although this share has been rising.

The benefits of outbound investment are manyfold and go beyond cost savings; benefits range from exposure and access to new international markets, information and contacts, an improvement in competition (including domestic competition), higher integration in the global value chains and ultimately, the flow on effects in Australia on the labour market (including in the creation of highly-skilled jobs) and economic growth.

Yet, outbound investment, particularly when it involves investment in offshore facilities (such as investing in a production facility or research hub in a foreign country) is often criticised by the media for moving jobs offshore.

Geopolitics and trade barriers

Current economic and geopolitical circumstances have seen something of a change in attitudes to globalisation, xenophobic views are obscuring the importance of trade and the benefits afforded by economic development based on both inbound and outbound investment. Global economic growth has increasingly been generated by developing economies, with the International Monetary Fund (IMF) describing the anemic economic growth in the developed world as "the new mediocre".

With the added trade barrier concerns stemming from Brexit and the Trump Presidency, Australia's economic future is surely linked to engagement with its immediate region where economic growth opportunities are substantial.

The Asian opportunity

The importance of Asia's economies has never been greater. Australia's existing relationships with Asia are largely built around commodity exports. The growth of Asia's middle class and the maturing of Asia's economies means that the demand profile of products and services will change. Demand for products like safe and high-quality food will rise – the good news is that Australia has a comparative advantage in those products.

With the growth of Asian middle classes, the cost of economic engagement in the region should fall. As a consequence, the level of economic engagement will grow significantly. It is unclear whether Australia has the right institutional settings to enable the economic integration that will help businesses to move up the economic value chain and to provide more than bulk commodities to Asian markets.

Australia has benefited more from globalisation than most countries and needs to address domestic scepticism to ensure these economic gains can be maintained. The alternative could potentially be a repeat of the post-World War II period, which saw a retreat from global integration followed by a gradual economic decline.

It is timely that both the Federal Government and Productivity Commission are undertaking major inquiries into Australia's foreign and trade policies. This should provide the perfect opportunity for the government to demonstrate strong leadership in clearly defining and publicising the considerable economic benefits that flow to Australian residents through outbound investment as a component of a more general open approach to globalisation.

Recommendations

The following findings offer recommendations for Australian institutions and businesses to overcome some of these barriers preventing them from taking advantage of the opportunity offered by outbound investment to Asia. They draw heavily on the chapters of this publication.

Cultivating economic diplomacy

With the election of President Trump and the subsequent adoption of "America First" policies, including the removal of US support for the Trans-Pacific Partnership, the advent of Brexit, and the emergence of growing anti-globalisation sentiments in Australia and around the world, it will become increasingly important for Australia to maintain strong international relations with our trading partners.

The Federal Government should:

- Define clearly through its Foreign Policy White Paper – and in any response to the Productivity Commission's research paper on international shifts in trade policy and their implications for Australia – the benefits of outbound investment to improving economic outcomes for the nation; and
- Continue its diplomatic and trade mission efforts to ensure new trade barriers are vigorously opposed.

Engaging with Asia

It is recommended that organisations should focus on Asia for outbound investment purposes.

As outlined in Chapter 4 of this report, there are several models for engaging with Asia, namely:

- The status quo, which involves Australia being a bulk commodity exporter;
- Developing a national champion for each export industry;
- Putting Australian products into the Asian supply chain through investment from Asia; and
- Outbound Australian investment to Asia in logistics and processing.

CEDA recommends that the focus should be on investing in Asia rather than remaining a bulk commodity exporter.

In making this recommendation, it is recognised that small-to-medium enterprises (SMEs) in particular may not have the capacity or capability to invest in logistics and processing plants in Asia. Regardless, they should consider some sort of presence in Asia. This is particularly important for Australian SMEs wishing to provide professional services in Asia. However, this recommendation does not preclude ensuring support exists for those Australian companies who have the capacity to invest in logistics and processing opportunities in overseas markets.

Drawing on recommendations by contributors to this publication, CEDA recommends that Australian businesses should:

- Appreciate that doing business in Asia involves having some sort of local presence and contacts;
- Take advantage of the existing human capital in Asia in the form of Australian expatriates and migrants living in Asia who possess the appropriate cultural, language and business skills required; and
- Be aware of the political, cultural and brand risks that are unique to doing business in Asia and take the appropriate steps to mitigate those.

Improving Australian institutions

As discussed in Chapter 2, our institutions, in particular, Austrade and the Export Finance and Insurance Corporation (EFIC), have been responsive to the Asian opportunity and are, overall, achieving their objectives of fostering better foreign investment. However, there is room for improvement.

SMEs, and even larger enterprises, have difficulties operating in some foreign markets, particularly in linguistically and culturally different countries such as China and India. In the case of SMEs, the problem is often poor access to information, knowledge and know-how required to operate overseas.

Drawing on Chapter 2, CEDA recommends that:

- Austrade and EFIC continue to ensure that Asia is a primary focus area when it comes to outbound investment;
- EFIC should re-focus its role on newly-exporting SMEs, particularly Australian SMEs wishing to export professional services to Asia, and with Austrade improve access to and quality of information and know-how on operating overseas.

Revisiting taxation incentives

There are conflicting views about whether or not the Australian taxation system is biased against outbound investment. The Henry Tax Review noted that since foreign taxes were not subject to dividend franking, it may discourage foreign investment compared to domestic investment. However, as discussed in Chapter 3, survey evidence suggests that the disincentive may not be significant.

Given the importance of incentives when it comes to investment, CEDA recommends that:

- The Productivity Commission should examine the effect of the Australia taxation system, and in particular, the effect of the current dividend imputation system, on outbound investment as part of its research paper on Australia's trade policy.

Creating food clusters

For some time, it has been argued that there is opportunity for Australia to become a premium food provider to Asia, including in the provision of high-quality, fresh and chilled food products.

However, to achieve this objective the first step starts here in Australia. Drawing on the recommendations made in Chapter 4, the industry should create food clusters in the form of "food processing and innovation metropolises".

This would involve:

- The creation of food processing centres in regional cities with good transport and infrastructure links; and
- Aligning intensive agriculture (such as chicken farms) with food manufacturing, services and logistics.

Once the food clusters are established in Australia, it would be critical to enable the integration of Australian products into the Asian and global value chain. Distribution systems for chilled and fresh food are often inadequate in much of Asia, offering an opportunity for Australian outbound investment.

Accordingly, Australian businesses could:

- Develop chilled food distribution channels in Asia; and
- Provide training in Asia to develop the skills and know-how of the Asian workforce when it comes to chilled food distribution systems.

Contributions

Outbound investment and the macroeconomy

Professor Renée Fry-McKibbin, Professor of Economics, Crawford School of Public Policy and Associate Dean (Research), College of Asia and the Pacific, ANU examines the macroeconomic factors in the global economy that affect outbound investment, the risks and opportunities associated with these factors and the reasons why Australian firms invest abroad. She concludes that early results show that the government may be able to influence investment decisions via the tax regime or labour market policies.

Institutional settings: adopting an outbound focus

The Hon. Dr Craig Emerson, former Federal Minister for Trade, examines the importance of globalisation in terms of Australia's economy. In this context, he explores the role that outbound investment can play at fostering closer links with the emerging middle-class markets in Asia and whether the nation has the right enabling infrastructure for small-to-medium enterprises. Historically, the majority of the focus in Australia has been to attract investment into the country, an important element of the nation's development. Now Australia has an opportunity to build the emerging markets in Asia and to capitalise on their growth.

The Asian opportunity

Andrew Parker, Partner Asia Practice at PwC, discusses that Australia is a trading nation, with high levels of exports and an economy with considerable international exposure. However, the level of foreign direct investment in Asia lags that of Europe or the US. He examines the rapid growth in intra-Asian trade that is outpacing the economic growth of the region. He explores reasons for Australia's relatively low level of involvement with the region and ways to improve it.

Integrating Australian agriculture with global value chains

Professor Alice Woodhead, Greg Earl and Dr Shane Zhang examine the need for Australian businesses to invest throughout the logistics and distribution chains when seeking export opportunities in Asia. They discuss the opportunities Australian businesses have in expanding their markets into Asia, but also describe the challenges associated with maintaining the standards that differentiate these products. In the context of agriculture, they outline how exporters hoping to maintain Australian quality standards require investments in developing economy infrastructure and service capability.

De-risking Asia

Megan Mulia, Director, Research and Information, Asialink Business, provides a series of case studies on what to do, and what not to do, to de-risk investing in Asia. She examines three particularly significant areas of risk that should be taken into account when considering an expansion into Asia, namely, political, cultural and brand risk. As shown by the case studies, it is crucial for Australia businesses to overcome these risks in order to be successful in Asia.

Acknowledgements

CEDA thanks the input and expert advice from the CEDA Advisory Group (CAG) in developing this policy perspective. The CAG consisted of:

- Diane Smith-Gander, Non-Executive Director, Wesfarmers;
- The Hon. Andrew Robb AO MP, former Minister for Trade and Investment; and
- Christine Holgate, Chief Executive Officer and Managing Director, Blackmores.

These distinguished experts provided guidance in creating this report. However, the final report is entirely the responsibility of CEDA and the individual authors.

CEDA overview

Sarah-Jane Derby

CEDA Senior Economist

Nathan Taylor

CEDA Chief Economist

With protectionist tendencies globally on the rise, the benefits of free trade are being pulled into question the world over. CEDA Senior Economist Sarah-Jane Derby and CEDA Chief Economist Nathan Taylor provide an overview on the current state of Australian outbound investment.

Despite greater global economic integration than ever before, there is evidence to suggest that globalisation may have reached its zenith, particularly in the developed world. In 2016, the two countries most responsible for the current global economic order both took decisive decisions to retreat from globalisation. In the UK, the decision involved exiting the European Union (Brexit) while in the US it was in the election of President Donald Trump whose mandate, “America First”, put much emphasis on protectionism.

Indeed, one of the first acts of President Trump was to withdraw from the Trans-Pacific Partnership Agreement, which the US had previously spearheaded. In addition to these political decisions, the volumes of global trade appear to have stabilised, if not fallen, during the last four years.[1]

The last time the world turned its back on free trade was after World War I and World War II. The world wars disrupted international trade, and so Australia followed suit and erected significant trade barriers. This was followed by an extended period of relative economic decline, a decline in competitiveness and below Organisation for Economic Co-operation and Development (OECD) average labour productivity growth.[2,3]

In contrast, the most recent period of globalisation has coincided with unprecedented economic growth for Australia, a small and trade-exposed economy. Increased exposure to globalisation since the 1990s has provided a boost to Australia’s efficiency and competitiveness, and has underpinned much of the uninterrupted economic growth we have been experiencing for the last 26 years.

Yet there are already signs that Australia is waiving away from free trade, with new procurement policies favouring domestic suppliers and increased resistance to foreign investment, particularly from Asia. This is somewhat concerning as Australia will only realise the full economic benefits of economic development with more, not less, global integration.

“There are already signs that Australia is waiving away from free trade, with new procurement policies favouring domestic suppliers and increased resistance to foreign investment, particularly from Asia.”

It is therefore timely that both the Federal Government and Productivity Commission are investigating and re-evaluating the economic and political advantages and consequences of international trade. A significant component of this will be the need to consider the issue of outbound investment.

State of play

As discussed by Professor Renée Fry-McKibbin in Chapter 1, Australia's investment abroad consists of:

- Foreign direct investment (26.1 per cent), which is essentially Australians investing in foreign equities and other direct investments which gives them at least 10 per cent control;
- Portfolio investment (39.1 per cent) which involves the purchase of debt or equity securities; and
- Other investment (34.8 per cent) in the form of financial derivatives, reserve assets and all other investment such as currency and loans.

The stock of Australia's investment abroad was, A$2.1 trillion at the end of 2015, an increase of eight per cent on the previous year.[4] Outbound investment or FDI, which is the focus of this report, amounted to A$542.6 billion in 2015.

By overseas market, 19.4 per cent of the stock of FDI was directed to the US, 15 per cent to the UK, 11.2 per cent to New Zealand, 3.9 per cent to Singapore and 2.6 per cent to China.[5] As shown in Table 1, as a share of total FDI, the US and New Zealand had lower shares in 2015 than they did a decade earlier. China, on the other hand, while still a small destination in terms of stocks, has been gaining in importance.

TABLE 1
TOP FIVE DESTINATIONS, STOCK OF FDI, 2015

Destination	2015 A$ billion	2015 Share (%)	2005 Share (%)
US	105.2	19.4	40.7
UK	81.3	15.0	12.0
New Zealand	60.5	11.2	13.9
Singapore	21.2	3.9	1.0
China	14.1	2.6	0.3
Total	542.6	100.0	100.0

Source: ABS Cat No. 5352.0

The ABS releases data on the breakdown of Australian outbound investment by industry according to the top enterprise in Australia that undertakes the investment. As shown in Table 2, the sector with the largest investments is financial and insurance services, followed by those funds that cannot be allocated due to privacy concerns, then the mining and manufacturing sectors. The share of outbound investment in the financial and insurance services sector has been rising, while the share going towards the mining sector has been declining.

TABLE 2
AUSTRALIA'S STOCK OF FDI BY INDUSTRY, PER CENT OF TOTAL

	2011 (%)	2015 (%)
Financial and insurance services	62.6	69.7
Unallocated	11.0	10.4
Other industries	7.6	6.9
Mining	12.0	6.1
Manufacturing	4.5	5.0
Rental, hiring and real estate	0.7	0.7
Wholesale trade	0.4	0.3
Electricity, gas, water and waste	0.6	0.3
Retail trade	0.3	0.3
Transport, postal and warehousing	0.3	0.2

Source: ABS Cat No. 5352.0

The stock of direct Australian investment in China, and Asia as a whole, is low relative to that in the OECD, but it has grown significantly in the last decade. This reflects a growing integration within the Asian region, albeit from a very low base, and the decreasing importance of investments in the OECD which have declined from 75.2 per cent of Australia's outbound investment in 2005 to just 53.5 per cent in 2015.[6] Despite the growth of outbound investment to Asia, it is still under-weight given the nation's export flows. Australia's history with manufacturing may, at least partially, be the reason behind this.

Partly because of its small population, relatively high labour costs and the past decades of tariff protection, Australia has developed very few mass market manufacturing industries. As a consequence, it has not experienced the same degree of dislocation arising from outbound investment that occurred in a number of industries that relocated labour-intensive processes into East Asia. Japan, Korea, and Taiwan, for example, have moved much of their manufacturing into China. Australia did not have much labour-intensive mass market manufacturing to move, and what it did have was relocated in the earlier waves of globalisation.[7]

> "While successful Australian businesses will always find it relatively easier to expand into countries with similar legal and cultural institutions, the growth of Asian economies will create a strong economic gravitational pull."

While successful Australian businesses will always find it relatively easier to expand into countries with similar legal and cultural institutions, the growth of Asian economies will create a strong economic gravitational pull. Larger developed economies in the same geographic vicinity in Australia will open up greater opportunities to trade and engage in business activity. As Andrew Parker points out in Chapter 3, ASEAN will soon become the world's biggest trading region, with inter-business trade exceeding that in the European Union. Investment by Australian businesses in the region will ensure that the nation benefits from the economic growth of Asia and is actively involved in its development.

"ASEAN will soon become the world's biggest trading region, with inter-business trade exceeding that in the European Union. Investment by Australian businesses in the region will ensure that the nation benefits from the economic growth of Asia and is actively involved in its development."

The benefits of outbound investment

Outbound investment, particularly when it comes to the relocation of production facilities, is often associated with job losses and viewed negatively by the public. Little is said about the benefits of outbound investment to Australia.

Austrade describes in great detail the main benefits of outbound investment, a summary of which is included here:[8]

- Outbound investment can improve competition – not just international competition but it could have flow-on effects on domestic competition as well. This could occur, for example, through cost reductions or economies of scale that would otherwise not be realised.
- Outbound investment can lead to a rise in high-skilled jobs in Australia. Greater participation in the global value chain may indeed lead to job losses for low-paid workers in manufacturing but it may also lead, for example, to the creation of R&D facilities located in Australia to service that same value chain.
- Outbound investment can improve market access, particularly for new markets. This is particularly important for service organisations as they require a presence on the ground. Without outbound investment, their access to Asian markets is limited.
- Outbound investment also facilitates access to new information and contacts in Asia and exposes Australian businesses to different business cultures which may enrich their know-how and help them to innovate back in Australia.
- Outbound investment may also create new growth opportunities for organisations in sectors where the market in Australia is saturated. This typically does not lead to job losses in Australia and creates higher profits for the organisation.

FIGURE 1
THE GLOBAL ECONOMY'S CENTRE OF GRAVITY

Source: Quah, D, 2011. Notes: The orange dots are projections.

The Asian opportunity

Australia's plethora of natural resources and geographic isolation have made its journey toward being a trading nation a natural progression. As the Asian middle class grows, Australia will be able to service the growing demand for high quality produce and food products. This will in turn lead to opportunities for further inter-connectivity and economic exchange, with Australia exporting its service and knowledge industries. Australia has the opportunity to actively engage in building the economic growth of Asia.

There is a lot of evidence that Asia is the place to be. In 1980, the global economy's centre of gravity (the average location of global economic activity as measured by GDP) was in the mid-Atlantic as shown in Figure 1.[9] By 2008, the centre had moved closer towards Asia, being located east of Helsinki and Bucharest and it is estimated to be between India and China by 2050.[10]

This represents an incredible opportunity for Australia. However, it will involve a concerted change in economic behaviour. It will involve much greater integration into Asian markets, particularly through two-way direct investment.

As discussed by Andrew Parker in Chapter 3 of this report, Asia now accounts for around 40 per cent of the world's gross domestic product (GDP), a 15 percentage points rise from 1990. The region accounts for two-thirds of global growth and by 2030, four of the world's five biggest economies in purchasing power parity (PPP) terms will be in Asia, namely: China, India, Japan and Indonesia. According to IMF projections, the middle class in China and India could amount to 1.5 billion people by 2020[11] – markets that offer significant opportunity for Australia.

Outbound investment is an important means of accessing these markets, and half of all companies investing overseas in 2016 did so for this reason. If Australian businesses are to move up the value chain and to export more than commodities, they will likely require significant engagement in Asia to provide higher value goods and services.

This is particularly true for the service sector. Service sector companies such as education providers and professional services organisations such as architect or accounting firms should have a presence in Asia in order to deliver their services.[12]

Inbound FDI into Australia over past decades has been a key driver of growth for Australia's exports, as well as growth of the domestic economy. Considerable analysis has been conducted to understand Australia's inbound investment profile. However, outbound investment can also benefit Australian companies, contributing to Australia's economic growth.

"Considerable analysis has been conducted to understand Australia's inbound investment profile. However, outbound investment can also benefit Australian companies, contributing to Australia's economic growth."

Conclusion

Australian businesses are already recalibrating towards Asia. As Asia has developed, so too has Australian outbound investment in the region. However, it has a long way to go before it achieves parity with the nation's trade flows. Australia needs to move away from its historic antipathy towards outbound investment and embrace it as a means of delivering high-quality goods and services into Asia. The default approach will be to rely on inbound investment to create the links between Australian expertise and Asian markets. An ideal outcome would involve both approaches, with Australia becoming more integrated into Asian markets.

Endnotes

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1. Outbound investment and the macroeconomy

Professor Renée Fry-McKibbin

This chapter sets out the macroeconomic context surrounding Australian investment abroad by discussing investment risks and opportunity, factors that affect investment decisions, and the key issues surrounding Australian investment abroad.

Professor Renée Fry-McKibbin lectures in economics at the Crawford School of Public Policy and is Associate Dean (Research) in the College of Asia and the Pacific at the Australian National University. She was Director of the Centre for Applied Macroeconomic Analysis (CAMA) in the Crawford School of Public Policy from 2012–2014 and also co-directs the Finance and the Macroeconomy, and Commodities and the Macroeconomy research programs in CAMA. She is a research associate of the Norwegian Centre for Macroeconomic and Petroleum Analysis, the Research Program in Forecasting at George Washington University and was an associate of The Cambridge Endowment for Research in Finance at the University of Cambridge (2008–2012).

She was on the advisory board of the Australian Defence College (2012–2014) and has been a visiting scholar at the European Central Bank, the Atlanta Federal Reserve, the International Monetary Fund, the Bank of England, Banque de France and the Reserve Bank of New Zealand. In 2016 she joined the Economic Society of Australia's National Economic Panel.

Professor Fry-McKibbin gratefully acknowledges the funding of her research by the Department of Foreign Affairs and Trade and the Australian Research Council (LP150100991).

Introduction

Australia is a net importer of capital mainly for structural reasons, most recently relating to the capital intensive needs of the mining industry. Traditionally, foreigners finance the capital expenditure needed for Australia to benefit from the resources of the economy.[1] The focus of policymakers and researchers in Australia has naturally been on capital inflows rather than capital outflows. However, there is surprisingly little analysis of the integration of Australia in global capital markets. In particular, the nature of Australian investment abroad has been overlooked. This omission represents a missed opportunity to understand the risks and benefits of Australian investment abroad for the Australian economy.

This chapter sets out the macroeconomic context surrounding Australian investment abroad by discussing the following questions:

1. What are the macroeconomic factors in the global economy representing investment risks and opportunity?
2. What are the macroeconomic factors that affect decisions to invest abroad?
3. What are the key issues surrounding Australian investment abroad for the Australian macroeconomy?

The discussion draws on Australian evidence where possible.

Australian investment abroad

The main focus of this chapter is investment abroad conducted by individuals and firms, rather than by governments and central banks. The two types of investment abroad considered are foreign direct investment (FDI) and portfolio investment. FDI is a category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise in another economy.[2] Portfolio investment is defined as cross border transactions and positions involving debt or equity securities, other than those included in direct investment or reserve assets.[3] The main distinction between FDI and portfolio investment is that FDI is associated with a 10 per cent or more voting power in the enterprise.

The latest statistics released by the Australian Bureau of Statistics (ABS) on Australia's international investment position were for the 2015 year-end.[4] The ABS reports that by 2015 the stock of Australian outbound investment was A$2080.7 billon. This figure represents an increase of eight per cent compared to 2014. The majority of investment abroad is portfolio investment including both equity and debt of A$512.4 billion and A$302.0 billion respectively. FDI is A$542.6 billion. Together, FDI and portfolio investments comprise 65 per cent of total Australian investment abroad. The remainder is other investment, financial derivatives and reserve assets. Over the past 20 years, Australia's investment abroad per year has been 4.25 per cent of GDP. For context, this compares to foreign investment in Australia of 8.5 per cent of Australian GDP over the same period.[5] The Department of Foreign Affairs and Trade have compiled a useful summary of the latest ABS data.[6]

The global macroeconomy and investment

The international economic landscape has changed significantly for investors since the Global Financial Crisis (GFC) in the US, the sovereign debt crisis in Europe, and the emergence of Asia, particularly China. It is worthwhile to review the current global macroeconomic debates about the environment for investment in the aftermath of these events. Several key trends have emerged in the macro-economy that create challenges but also opportunities for Australians wanting to invest abroad.

Secular stagnation and the productivity slowdown

Recovery from the crises for advanced economies has been slow. In addition to low global demand and low rates of economic growth, investment, particularly by business, is weak. GDP and demand in Europe have not returned to their pre-crisis levels. For most countries, despite the passage of a decade, investment growth has not returned to pre-crisis trend.[7] The US is recovering more strongly than most with the Fed indicating that the policy interest rate will increase over 2017. However, despite the economic recovery in the US in terms of growth and employment, business investment in the US has also been slowing. Drawing on the Depression era term, Larry Summers has named this phenomenon of weak investment growth "secular stagnation". This has sparked fierce debate about its likely causes and remedies.[8] Global productivity slowdown is a key reason for weak global investment. Productivity shocks appear to be correlated across countries over time. In addition to the demographic effects of an ageing population, several reasons have been posited for the productivity slowdown.[9]

"GDP and demand in Europe have not returned to their pre-crisis levels. For most countries, despite the passage of a decade, investment growth has not returned to pre-crisis trend."

Natural rate of interest

One view is that the real natural rate of interest, which is the full employment interest rate equilibrating savings and investment, is much lower than it has been historically. The natural rate of interest for the US has dropped sharply over the last decade.[10] The same result is found for the UK, Canada and the Euro area, indicating some global trend in the natural rate.[11] For Japan the natural rate of interest is close to zero.[12] The reduction in the natural rate of interest makes it difficult for central banks to affect aggregate demand and in turn global investment by lowering interest rates. One implication is that for most advanced countries, monetary policy interest rates are likely to remain low and close to the zero lower bound.

Technological progress

Another view posits that the productivity slowdown reflects the exhaustion of gains from technological process. In addition, recent technological advances have only benefitted a small sector of the economy in industries such as entertainment, communication and information. Productivity in other sectors such as manufacturing, health care and transportation has been growing slowly.[13]

This means that the benefits of the recent technological expansion have not been spread equally across society, leading to an increase in inequality.[14] The political dissatisfaction in many segments of the economy relate to this inequality generated by technology. The inequality is exacerbated by the gains by asset holders through post crisis policies designed to prop up asset values, such as the quantitative easing policies of some central banks.[15] The reduction in productivity growth and the increase in inequality in turn results in a reduction in expected future growth, which further suppresses investment.

> "Recent technological advances have only benefitted a small sector of the economy in industries such as entertainment, communication and information. Productivity in other sectors such as manufacturing, health care and transportation has been growing slowly."

Liquidity trap

The arguments so far for secular stagnation – whether it has been caused by either a low natural rate of interest or technological progress – are related to the recent version of the liquidity trap argument of Krugman.[16] The crux of the argument is that conventional monetary policy is not able to stimulate the economy. In the liquidity trap, savings exacerbate slow growth as well as investment declines. During past crises, the liquidity trap was seen to be a temporary phenomenon, overcome by generating inflationary expectations. In the current environment the liquidity trap is not seen to be temporary.

The savings glut

Bernanke takes a slightly more optimistic view of the secular stagnation hypothesis by taking a global perspective.[17] One argument for low real interest rates is the global savings glut that emerged out of China and other countries in the Asian region. This excess of savings is the longer term implication of their own policies following the turmoil of the Asian financial crisis in 1997–1998. The policies of reserve accumulation, exchange rate management and lack of confidence in domestic investment opportunities necessitating a need for diversification led to substantial current account surpluses. Much of this surplus flowed to developed countries, creating downward pressure on the major interest rates, contributing to the eventual decline in advanced countries. Recently, this trend has reversed with current account surpluses of emerging countries declining since 2008. Bernanke's solution to the sectoral stagnation problem is increased foreign investment and trade. As imbalances in trade and financial flows are corrected, global interest rates will rise, leading to better global growth outcomes.[18]

Macroeconomic policies

Weak global investment by the advanced economies is not because of a lack of funds to invest. However, compounding the challenges is the abundance of evidence that macroeconomic uncertainty, and particularly macroeconomic policy uncertainty, is a factor contributing to weak investment.[19] The inability of monetary policy to provide the stimulus to the global economy in terms of productivity and business investment has led to a suite of new radical policies emerging.

One such policy is the negative interest rate policy that several central banks have implemented including the Danish National Bank, the European Central Bank, the Swiss National Bank, the Bank of Japan and the Central Bank of Hungary. The basis of the policy is that central banks charge, rather than pay, commercial banks to hold their reserves. The Swiss and Danish banks used this policy to stem capital inflows, which was placing upward pressure on their relative currencies, while the others have negative rates to achieve their inflation and growth targets.[20] The view on the sensibility of such a policy is mixed. The main risks include increased risk taking, particularly into emerging markets, and pressure on bank profitability, particularly if these polices are in place for a long period of time. To date the policy has not led to the desired results, with inflation expectations still lacklustre in most countries, while the Japanese Yen and Swiss franc have appreciated.

The most obvious macroeconomic policy to address the productivity slowdown is infrastructure investment, particularly given the close to zero interest rates. In the case of the US for example, federal infrastructure investment is at a six decade low.[21] Infrastructure growth policies would present opportunities for Australian investment abroad. The reason that strong infrastructure expenditure may not come to fruition is that most countries with high debt do not want to increase their debt to GDP ratios even higher because of the effects that the debt burden has on future growth.[22] Those advocating the problems of secular stagnation argue that infrastructure investment must occur despite the high debt levels, and that it can be accommodated given close to zero interest rates. The tensions between increasing debt and needing infrastructure to kick-start growth is a politically contentious issue.

"The most obvious macroeconomic policy to address the productivity slowdown is infrastructure investment, particularly given the close to zero interest rates."

Asia

By 2050, China is expected to comprise about 28 per cent of world output, and India around 13 per cent.[23] China's growth trajectory in particular has been remarkable, with annual GDP growth between 1980–2015 of 9.3 per cent.[24] China's share of global GDP in 2015 is about 17 per cent, which is higher than that of the US and the European Union.[25] Emerging markets as a whole comprise 50 per cent of global GDP.[26] Australia and the region, not to mention the global economy have benefitted substantially from this growth, with emerging markets being one of the economic bright spots over the past decade. Recently, concern

has emerged about a slowdown in China and its impact on global growth. The International Monetary Fund's (IMF) most recent growth forecast for China is 6.5 per cent, well below the 9.3 per cent on average of the past 35 years.[27]

China is currently transitioning from an economy dominated by high levels of savings and investment as well as exports, to one that is building its own consumption and services base and hence reducing its savings and investment as part of a deliberate development strategy. This slowdown in the growth of the Chinese economy is consistent with the transition from a middle to high income economy, and has much in common with the transition to development undertaken in both Japan and Korea.[28] Recent studies are optimistic about the future of the Chinese economy assuming that appropriate policies consistent with stable development are pursued. However, there are vulnerabilities. The IMF has pointed to the policy stimulus as being the current source of growth in China, which is unsustainable long term.[30] It is also likely that as China evolves, industries trading with China will be affected, depending on the nature of their trade linkages. Winners and losers will be determined by their relative economic structures.

Perhaps the most important factors in China's development, from an international investor perspective, are the developments in the financial sector as China gradually becomes more open. Policies to allow investment of foreigners in China are limited, exacerbated by foreign exchange controls.[31] The opening of China's financial sector is not likely to be smooth. The equity market volatility of 2014–2015 led to intervention by the government to prevent the market decline which was not viewed favourably by global markets.[32] Further, there is concern about the transparency and governance of companies trading on the stock market, which does not bode well for an efficient system. The concern is that volatility in Chinese stock markets will increasingly spill over to the foreign stock markets, making the international investment environment more volatile, particularly for other emerging markets.

Factors that affect investment abroad

There is not a particularly strong consensus on what macroeconomic factors drive investment outflows, and little has been written on the factors that affect outbound FDI and portfolio investment specifically for Australia. The most recent article on the topic of outbound FDI, and one of the very few articles written specifically using Australian data was published in 2010 and uses data between 1994 and 2007.[33] For Australian portfolio investment abroad there is also little empirical work, and even less on the macroeconomic factors driving it.[34] There is a clear need for further research to better understand the importance of macroeconomic variables in investment abroad decisions.[35] This section reviews the reasons that Australian firms invest abroad, and then discusses the macroeconomic factors more generally that affect foreign investment.

Reasons that Australian firms invest abroad

There is little information available on the reasons that Australian firms choose to invest abroad. The most comprehensive analysis of the issue is by the Productivity Commission who undertook an extensive survey of the reason that Australian firms choose to operate overseas, and the implications of that investment for the Australian economy. However, this publication is dated having been published in 2002, with the survey data collected in 2001.[36]

It would be worthwhile for the Productivity Commission to repeat this survey to reflect current economic structures and external circumstances, particularly in the context of an additional 15 years of globalisation, the commencement and unwinding of the mining boom period, the rise of China and the Asian region, new environmental laws, the GFC and the technological advancement of the current age. Knowing the reasons for firm expansion abroad is the crux of understanding the potential macroeconomic implications of FDI.

With the caveat of time passed in mind, the findings of the Productivity Commission are worth restating. These are that of the 201 large firms who responded to the survey 50 per cent of them have or planned to invest through FDI, while only four of the respondents planned to move their headquarters offshore. The main factors in the decision to invest overseas were commercial factors, particularly access to overseas markets, followed by foreign taxation rates rather than factors that the Australian government had any control over. Access to lower priced material and labour inputs was of secondary importance compared to commercial access.

Of those factors affecting investment abroad that the Australian government had any control over, the Australian taxation regime featured most, followed by labour market policies. At the time that the report was written one of the fears for encouraging outbound investment was that it would result in a reduction in economic activity within Australia. The survey indicated that for most countries FDI is a complement rather than a substitute for domestic activity. Few reported falls in domestic activity, while most reported no change or an increase in activity.

> "The exchange rate, exchange rate volatility and exchange rate regime are often cited as factors contributing to foreign investment decisions."

The 2002 report also indicated that the operations of 85 per cent of the respondents with offshore investment were similar to the core operation in Australia, indicating horizontal integration during that time. The industry composition of the stock of Australia's outbound FDI was 65 per cent for manufacturing, 22 per cent for finance and insurance and five per cent for mining. Goodman (2015) provides an overview of more recent statistics relating to the industry composition of FDI for 2013.

In the interim 12 years between the compilations of the statistics, the composition of outbound investment changed significantly. The same three industries dominate but the order of magnitude differs with a share of 29 per cent for mining, 28 per cent for finance and insurance and 13 per cent for manufacturing. Another way to slice the data is to look at the share of companies in a particular industry with overseas investments. The largest of these is mining with 53 per cent of companies in the mining sector having overseas direct investments, 52 per cent of companies in education and training, 50 per cent of companies in personal, scientific and technical services, 49 per cent of companies in administrative and support services, and 44 per cent of companies in the manufacturing sector.

The destination countries for outbound investment have also changed between 2001 and 2015. In 2001, the share of the stock of outbound FDI was 46.7 per cent for the US, 15.9 per cent for the UK and 7.1 per cent for New Zealand.[37] The top three outbound destination countries have not changed, but the proportion of FDI in the US declined in terms of the share of the stock of FDI to 19.4 per cent. The outbound stock in the ASEAN countries taken as a whole increased from 2.8 per cent of the stock of outbound FDI to 6.9 per cent. Again understanding of the factors for outbound investment for these industries remains unknown in 2017.

Macroeconomic factors that affect investment abroad

The main macroeconomic factors identified to affect FDI and portfolio outflows are market size, the interest rate, the exchange rate, and macroeconomic stability.

Market size: There is a general consensus that real GDP of the host country is a significant determinant of both outbound FDI and portfolio investment of a home country. This is because a larger economy is associated with higher demand, market opportunity and economies of scale. Most of the evidence finds that this is indeed the case. However, the evidence is not always consistent with this hypothesis. For example, for UK mergers and acquisitions, host country GDP is significant, but negative.[39] The rationale is that for the case of the UK, an increase in GDP in the host country leads to a decrease in outbound investment as it is more expensive to invest in foreign companies. On balance it is probably the exchange rate that will matter.

Exchange rate, exchange rate volatility and the exchange rate regime: The exchange rate, exchange rate volatility and exchange rate regime are often cited as factors contributing to foreign investment decisions. The exchange rate is a relative price that reflects the home and host country differences in terms of a range of factors not limited to macroeconomics, productivity, and financial asset markets.

The exchange rate and foreign investment need to be recognised as being endogenous with effects on both home and host markets, and being affected by both home and host markets.[40] The effects of the exchange rate on macroeconomic

outcomes relating to foreign investment will differ depending on the economic source of shocks causing exchange rate movements, as well as the location of the shocks in being either home or host country sourced.

For example, consider a contractionary monetary policy shock in the host market such as through an increase in the foreign interest rate, which leads to an appreciation of the host country currency relative to the domestic country. The monetary shock will lead to a reduction in demand in the host market, which will impact on the profitability of foreign investments. However, the appreciation of the host country currency will allow for profit repatriation at a better rate. Whether or not the increase in domestically valued profits will offset the effects of the reduction in demand in the host country will depend partly on the elasticities of the host country demand in the relevant sector.

The evidence on the level and volatility of the exchange rate on foreign investment decisions is mixed.[41] Some find that the home country appreciation will lead to FDI outflows as the relative wealth positions of countries change.[42] Others find that the exchange rate does not matter. Nonetheless the exchange rate has a long term bearing on the benefits of FDI in particular, as those decisions are difficult to reverse compared to portfolio investment. Some of the effects of the exchange rate will depend on the reason for FDI in the first place, as either being for horizontal or vertical integration.

A fixed exchange rate regime of the host country gives some certainty to investment decisions given the reduction in volatility. However, judgement is required as to the current and future appropriateness of the value of the exchange rate and the likelihood that the currency regime will remain in place if the exchange rate is not consistent with economic fundamentals.

The risk of investing in a market with a floating currency is mainly related to the volatility aspect. However, a floating currency regime is more likely to be associated with healthy competition and has the added advantage that in the case of adverse shocks, the exchange rate is able to adjust, providing a mechanism of recovery for the host country in which the investment is located. There is much that companies can do to hedge their currency risks to eliminate the uncertainty associated with the stock market. Further, there is evidence that preference for holding assets denominated in a particular currency can also affect FDI and portfolio investment decisions. For the US in particular, depreciation encourages the aggressive bidding for dollar-denominated foreign assets.

> "Investments by firms engaging in vertical foreign direct investment, where only parts of the production chain are relocated, are generally found to be complementary to domestic exports and do not reduce them."

Interest rate: The interest rate, which represents the cost of capital, is another variable with ambiguous effects on the location decisions of FDI and portfolio investment. The outcome depends on the ability of a firm to finance their investments from their home country or the host country. Firms that are able to access funds in either the home or host market for investment purposes are able to

maximise profits by borrowing in the least expensive location. This can also give foreign firms an advantage over domestic firms in a host country.[43] It has been shown that the host country interest rate is a significant factor in the location of FDI for advanced countries.[44]

Macroeconomic stability: Macroeconomic stability more generally is a feature that firms consider when investing abroad. A stable macroeconomic environment consisting of stable inflation, sustainable government debt and sustainable fiscal deficits/surpluses are conducive to growth and foreign investment.[45]

Evidence for Australia: The evidence is that Australia tends to invest directly in countries that are open, have a large domestic market and a similar language and culture to Australia. Investment also tends to occur in countries that provide access to surrounding regional markets. A surprising result is that Australian firms do not tend to invest in countries with a high level of knowledge capital. In a study of inward FDI flows to Australia, the interest rate was also a significant factor; however, the study found that higher interest rates were associated with more FDI inflows.[46] For portfolio investment, the consensus is that governance, market size, cross border capital controls and transaction costs matter most. However, there is a clear home bias in portfolio investment.[47] There is evidence that if firms diversified their portfolios internationally, then there would be a reduction in borrowing costs of two per cent.[48]

Issues for consideration

Domestic macroeconomic effects of outbound investment

A popular argument in the press is that investment abroad reduces domestic exports, employment and growth, as well as investment in the domestic economy. However, whether this is true depends upon the reasons for outbound investment.[49] Investments by firms engaging in vertical foreign direct investment, where only parts of the production chain are relocated, are generally found to be complementary to domestic exports and do not reduce them.[50] This is often the case when firms want to take advantage of less expensive factors of production. If investment decisions are made for horizontal integration reasons, then investment in the home country would fall. However, if the relocation for production purposes leads to an increase in the host country's demand for the goods and services, and if the production involves some exports from the home country to the host country, then the overall effect is not clear.[51]

The effects of investment abroad also have implications for the domestic interest rate and the exchange rate. Investment outflows are essentially a relocation of domestic savings to the host countries. For a country like Australia with a high savings rate, but in need of high levels of investment, investment abroad will reduce the available domestic capital stock, and may lead to upward pressure on interest rates, assuming that the domestic firms fund their investment through a domestic source.[52] This effect may be moderated by the fostering of new trade

and service opportunities that arise through the location effects of the new investment. An outflow of capital will result in a depreciation of the Australian dollar. This in itself will also act as a stimulus to Australian exports. However, repatriation of profits from the outbound investment back to Australia will in turn result in an appreciation of the Australian dollar. Again, a careful empirical analysis of the Australian data is needed.

Capitalising on globalisation

The 2014 Financial System Inquiry found that Australia is less open and integrated than it could be, and less open than it will need to be in the future.[53] Globally, capital market integration is an important economic objective of most regions. Following the Asian financial crisis, the ASEAN economic community was formed and a blueprint for economic integration was written with the objective of the flow of goods, services, investment and skilled labour, as well as a freer flow of capital.[54] Although there is a lot of progress to be made, China has a range of reforms planned for their currency and capital controls over time. An argument for forming the European Union and adopting the Euro in Europe was that greater market integration, including capital market integration, would naturally follow. In the European context, capital market integration is believed to lead to economic resilience, competition, diversification and risk sharing.[55]

Australia's current largest export markets as a percentage of total exports in 2015–2016 are 27.5 per cent for China, 12.2 per cent for Japan, seven per cent for the US, 6.3 per cent for Korea, 4.1 per cent for India and 4.1 per cent for New Zealand.[56] Despite the tremendous growth in the Asian region over the last decade, Australian investment in the region is remarkably small. The current destinations for Australian investment abroad are the US and the UK with 29 per cent and 17 per cent of the total respectively. The next host countries for Australian investment are located within the Asian region and include five per cent for New Zealand, four per cent for Japan, three per cent for China and three per cent for Singapore.

"The expected movement of global GDP to be centred on the Asian region, and China and India in particular in the coming decades, surely presents tremendous opportunity for Australian firms to invest in the region."

The expected movement of global GDP to be centred on the Asian region, and China and India in particular in the coming decades, surely presents tremendous opportunity for Australian firms to invest in the region, and to also be a conduit into Asia for others markets that Australia has strong relationships with. This conduit may be through the use of the Australian dollar, which is the fifth most traded currency with a daily average foreign exchange turnover of US$632 million in 2013.[57] This equates to around 11.8 per cent of total daily foreign exchange turnover, while Australian GDP is 1.6 per cent of world GDP.[58] The only other currency in the region more highly traded is the Japanese Yen. The Johnson report *Australia as a Financial Centre* recommended that Australia should be developing

into a leading financial centre in the region, with one aim to increase business opportunities offshore, capitalising on the efficiency of Australia's financial sector, skilled workforce and regulatory frameworks.[59]

However, with the context of the global investment environment raising a lot of challenges and uncertainty – and given that Australia remains a long term net importer of capital – the obvious question is: why invest overseas? It is fundamental that savings be invested most productively. The opportunities for profitable domestic investment is one reason for the low investment rates abroad.

In addition to the firm specific benefits identified previously in terms of access to export markets and production chains, having open capital markets has advantages for the broader macroeconomy which extend beyond the returns to the dollar amount invested in either FDI or portfolio investments. First, there is evidence that overseas investment encourages further trade. Second, access to international capital markets, and most likely those in Asia, is essential for the future economic development of Australia. Open capital markets place pressure on the Australian financial system to be competitive, increasing the efficiency and the deepening of the Australian financial system, in turn making Australia an attractive place to invest.[60] Enabling access to global financial markets for Australian firms also allows competitive funding of their activities. Finally, foreign investment also diversifies risk.

There are macroeconomic risks associated with increased financial integration, including through increased financial market volatility and potentially the transmission of international financial market crises to Australia through asset markets. This is commonly known as contagion. Previous episodes of global crises have affected Australian financial markets through this volatility and is evident most in the collapse of the Australian dollar during these times. However, Australia has come through the recent crisis with little adverse impact from the corresponding global investment slump. In fact, Australia has potentially benefitted from the contraction in the rest of the advanced world, being one of the very few advanced countries that has not suffered a recession in the past decade, and has become an attractive destination of inward investment. For this to be the case during crisis episodes in the future, macroeconomic policy settings, including macro-prudential policy settings, need to be strong.

Australian investment abroad and the commodity cycle

Recent policy options for moderating the effects of the resources boom – in terms of the distributional effects across the sectors of the economy – have touched on Australian investment abroad as a policy tool through the formation of a sovereign wealth fund that primarily invests overseas.[61] The main concern is for Dutch Disease where the domestic currency appreciates substantially, increased export income, high commodity prices and foreign capital inflow. This effect on the exchange rate is slightly offset by corresponding outflows to the rest of the world

through imports and remittance of dividends, but not by enough to dampen the exchange rate appreciation.[62] The effects of the boom are different for the mining sector and those that compete in tradeable sectors where global prices have not risen like those in the mining sector. In addition, resources also move from these less profitable sectors to the booming sector. The currency appreciation makes imports expensive and exports less competitive, reducing incomes of these sectors in Australian dollar terms. Examples of the sectors include manufacturing, agriculture, tourism and education.[63] Traditional policy options such as monetary policy have been shown to be ineffective in restraining the mining industry during resources booms.

The argument for a sovereign wealth fund that invests offshore is that diverging the fiscal surplus of the commodities boom would take some of the heat out of the stimulus to the economy from the commodity stimulus, in effect alleviating the distributional effects of the commodities boom. A sovereign wealth fund could ensure intergenerational equity of the proceeds of Australia's natural resources, and reduce real exchange rate appreciation – which would take pressure off the sectoral adjustment that is a likely consequence of the effects of Dutch Disease.[64]

A further advantage for Australia investing mining windfalls offshore is that, if necessary, the proceeds of the sovereign wealth fund can be repatriated when the commodity cycle is in a trough, providing a buffer to the economic adjustment when needed. This policy is not agreed upon by all. If the proceeds of the mining boom are invested to increase production capacity through infrastructure and human capital investment the intergenerational distributional impacts can be avoided. There is also an argument that the time profile of profitable mining investment in Australia is up to 50 years, meaning that in the Australian context there is less concern about the intergenerational aspect. Finally, it is argued that it is unlikely that all proceeds of the mining boom would be invested in Australia by a sovereign wealth fund anyway given the capital importing needs of Australia.[65]

Concluding remarks

Sectoral stagnation, low global productivity, low natural interest rates, liquidity traps, the technological revolution, as well as the distributional consequences of the economic policies post 2008, make the international investment environment a challenging one. On the other hand, low interest rates and our place in the Asia Pacific region in particular provide unique opportunity for investment abroad

There is insufficient evidence on reasons that Australian firms choose to invest abroad, and hence it is difficult to provide a full analysis of the macroeconomic implications. International investment decisions are made relative to foreign opportunities, making any simple analysis superficial and unlikely to be informative. However, indications show that the factors the Australian government can use to influence investment decisions are the Australian taxation regime, followed by Australian labour market policies. For a proper understanding of the implications of Australian investment abroad, it is clear that more work needs to be done.

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2. Institutional settings: adopting an outbound focus

The Hon. Dr Craig Emerson

This chapter argues that for Australia to reap the benefits of consumer demand from Asia's growing middle classes, government agencies need to focus their support on small to medium-sized enterprises (SMEs) seeking to trade with and invest in those markets. It examines whether Australia has the right institutional settings to support an outbound focus for business.

The Hon. Dr Craig Emerson is an eminent economist, holding a PhD in economics from the Australian National University, with 35 years of experience in public policy, politics and public service. He was Senior Adviser to former Prime Minister Bob Hawke from 1986 to 1990 and, after entering parliament in 1998, went on to serve as Minister for Trade and Competitiveness; Minister for Tertiary Education, Skills, Science and Research; and Minister Assisting the Prime Minister on Asian Century Policy between 2010 and 2013. Dr Emerson is now Managing Director of Craig Emerson Economics, President of the Australia China Business Council NSW, Adjunct Professor at Victoria University's College of Business, a columnist for *The Australian Financial Review,* and a member of CEDA's Council on Economic Policy.

Introduction

Most of Australia's public discussion and policy attention concerning foreign investment relates to inbound investment. While encouraging inbound investment to supplement domestic savings and setting the appropriate policy framework for doing so remain vitally important to Australia's transition from the end of the mining boom, little attention has been paid to the role of Australian outbound investment into the rapidly growing economies of Asia. Such investment can integrate the Australian economy more fully into the economies of Asia, securing new opportunities for income growth and job creation at home.

The potential benefits of outbound investment include reduced input costs through the establishment of more efficient supply chains, stronger business relationships and improved standing with provincial and national governments. Yet, the benefits are likely to vary from one industry to another. China, for example, is already moving out of labour-intensive and heavy manufacturing. As the world

journeys further into the Digital Age, artificial intelligence will increasingly replace routine jobs. The influence of relative labour costs in determining location is likely to wane, though proximity to final market will be an important consideration for mass-produced manufactured goods. Individualised manufactured goods produced by 3D printing will be footloose. The prospective benefits of outbound investment in safe, premium food and beverage products are larger, though suppliers will not need to create their own distribution networks in importing Asian markets.

Services provided to foreigners visiting Australia, such as tourism and education, require inbound investment into Australia and a marketing presence in Asian countries. But unless tourist, education and training facilities are to be constructed in Asia, they do not require large amounts of outbound investment. However, Australian businesses seeking to provide services *within* Asian markets, such as advisory, architectural, urban development and health and aged-care services, *do* need a local presence in those countries. A fly-in, fly-out approach will not work in Asia.

Although there has been some shift in the primary destinations of Australian outbound investment over the last 15 years, it remains heavily concentrated in English-speaking and familiar markets, such as Europe, North America, New Zealand, Singapore and Hong Kong, where regulatory regimes and legal systems are mature. Outbound investment from Australia to China remains low, although a sharp increase has occurred in the ASEAN countries, albeit from a low base.

Australia's institutional framework for outbound investment has undergone important changes since the beginning of the current decade. Austrade's focus has shifted from established markets to emerging and frontier markets, especially in Asia. This shift denotes recognition of the market failure associated with the information difficulties faced by small and medium-sized enterprises (SMEs) in newer, less-sophisticated markets. Similarly, the Export Market Development Grants (EMDG) scheme administered by Austrade has been reoriented to focus on SMEs operating in Asia.

> "Most of Australia's public discussion and policy attention concerning foreign investment relates to inbound investment."

Australia's Export Finance and Insurance Corporation (EFIC) has also undergone a review, leading to an increased emphasis on export-ready SMEs seeking to operate in Asia. However, it is still expected that the majority of EFIC's support will go to larger corporations – a situation that has been criticised by the Productivity Commission.

If Australia is to integrate its economy more fully into the rapidly expanding economies of Asia to take advantage of the consumer demand from their growing middle classes, government agencies will need to focus their support on SMEs seeking to trade with and invest in those markets. Outbound investment in Asia by Australian SMEs has the potential to put Australia on a stronger, more enduring growth path with better prospects for job creation at home.

Why should Australian businesses be engaged with Asia?

Despite a recent increase in economic growth in the US, global growth continues to be driven by developing countries, particularly the emerging economies of Asia. In terms of purchasing power parity (PPP), China, India and Indonesia are now the world's largest, third-largest and eighth-largest economies respectively.[1] The International Monetary Fund (IMF) projects economic growth in Advanced Economies to be around 1.7 per cent per annum to 2021, while for Emerging and Developing Asian Economies, growth is projected to be in the order of 6.4 per cent per annum – almost four times the growth rate in the developed world.[2] Although growth in Asia is likely to moderate somewhat during the 2020s, it will decisively outpace that of the developed world over the course of that decade.

As pointed out in the *White Paper on Australia in the Asian Century*, the centre of economic gravity will continue to shift from North America and Europe to Asia:

> "The Asian century is an Australian opportunity. As the global centre of gravity shifts to our region, the tyranny of distance is being replaced by the prospects of proximity. Australia is located in the right place at the right time – in the Asian region in the Asian century."[3]

The number of middle-class consumers in the Asia-Pacific region is projected to grow from an estimated 525 million in 2009 to 3.2 billion by 2030, increasing the region's share of the global middle class from 28 per cent to 66 per cent.[4] While Europe and North America are projected to account for 30 per cent of middle-class spending in 2030, the Asia-Pacific region's share is projected to be almost double that, at 59 per cent.[5]

The white paper's message about the opportunities presented to Australia by Asia's burgeoning middle class is reinforced by a more recent analysis of Australia-China economic opportunities conducted by the East Asian Bureau of Economic Research and the China Center for International Economic Exchanges:

> "China's large and increasingly wealthy middle class will drive massive growth in consumer spending in the coming years."[6]

And, later in the document:

> "China's large and growing middle class will demand an increasingly broad range of goods and services, providing vast opportunities for exporters in areas from financial services to food…"[7]

Although the potential benefits for Australian businesses of Asia's rise are not in question, the most effective means of achieving those benefits are. Can Australian businesses operate at a distance, relying on exporting goods and services from Australia, or do they need to commit investment funds to developing their presence and capacities in those markets? Most of the discussion about foreign investment between Asia and Australia is about the policy framework for inbound investment in Australia. However, relatively little attention has been paid to the role of Australian investment bound for Asia. This chapter makes a contribution to that important, but largely neglected, topic.

Benefits of outbound investment from Australia to Asia

Until recently, outbound investment by businesses in advanced countries has mostly entailed offshoring manufacturing operations and back-office services to developing countries with lower wage rates and weaker environmental standards. Offshoring from the US during the past several decades to countries such as China, Vietnam and Bangladesh has been a politically unpopular practice, to the point where US President Donald Trump campaigned vigorously against it in the lead-up to the recent US election. Yet, many of the offshored products and services have formed inputs into supply chains leading back to the offshoring countries' markets, lowering costs and retaining competitiveness for the domestic producers of the goods and services.

Major businesses in developed countries, especially those operating in the financial services sector, have offshored their information and communications requirements to India in particular, taking advantage of both lower wage rates and the expertise developed in locations such as Bangalore. Increasingly, tenders for digital services are being let through online processes with bids coming in from around the globe. As this trend continues, routine advisory services such as accounting and legal services will be provided online, supported by artificial intelligence.

"As the world journeys further into the Digital Age, jobs lost through offshoring will increasingly be replaced not by jobs created in the developing world, but by robots possessing artificial intelligence."

With China continuing to shift out of labour-intensive and heavy manufacturing, in accordance with its 12th and 13th Five-Year Plans, some Chinese operations will move into developing countries with lower wage rates. Reshoring of energy-intensive manufacturing to originating countries will occur, most particularly to the US where manufacturers are taking advantage of low-cost shale gas.

However, as the world journeys further into the Digital Age, jobs lost through offshoring will increasingly be replaced not by jobs created in the developing world, but by robots possessing artificial intelligence. As explained in a KPMG report published in 2016:

> "…optimists about future productivity-raising inventions are not optimistic about future job prospects. Routine tasks will disappear to robots and digital technologies."[8]

For routine jobs, relative labour costs will be less important in determining the international location of industries. The location of facilities for large-scale manufacturing of consumer products will be heavily influenced by proximity to final markets. In the Digital Age, the expansion of 3D printing will neutralise wage-cost advantages for individualised and small-scale advanced manufacturing.

Reshoring might not be limited to energy-intensive manufacturing. As relative cost structures become less important in the Digital Age, businesses that have offshored labour-intensive manufacturing and services might find that regulatory

risks in emerging regional markets do not justify an investment presence in those markets. If the location of commercial activities is being determined less by the relative cost structures of different countries and more by expertise developed and offered through the internet, why should Australian businesses want to invest abroad, particularly in Asia?

Since Asia's burgeoning middle class and ongoing urbanisation will provide the main growth opportunities for Australian businesses seeking to export, the question becomes whether or not exports can be organised primarily from a home base in Australia, relying on local distributors in export markets to deliver the products and services into consumers' hands.

In answering this question, it is necessary to distinguish between the export of products and that of services. In turn, a distinction needs to be drawn between bulk commodities, such as iron ore, coal and liquefied natural gas (LNG), and more specialised, high-value goods, such as premium-quality processed foods and beverages. In respect of services, the relevant distinction is between services delivered in the overseas market, such as financial, advisory and urban design services, and those delivered in Australia, most particularly tourism and higher education services.

Bulk commodity exports are not considered in this report, since they are conducted by large, multinational corporations with well-established marketing systems. The discussion that follows relates to specialised, high-quality goods exports, and to services provided in the importing country as well as services provided in the exporting country that are counted as exports.

Specialised, high-value goods exports

Australia has competitive strengths in exporting packaged, safe, green, premium food and beverage products to the middle classes of Asia. In order to assure the safety and authenticity of these exports, supply-chain integrity is essential; the potential returns on counterfeiting and substitution of inferior products are very large. For this reason, middle-class consumers strongly prefer the products to be processed and packaged in the originating country, despite the much lower labour costs of processing in the importing country.

Under these circumstances, Australian SMEs producing premium foods and beverages will have little to gain from seeking to invest in processing facilities located in the importing Asian markets. For large exporters, such as producers of dairy products, the story might be different. For instance, New Zealand's major dairy processor, Fonterra, is investing in dairy farms and processing facilities in China.

Australian SME exporters of premium produce need to develop commercial relationships with one or more of the well-established, giant distribution companies operating in Asia's consumer markets. Creating their own distribution systems will usually be impractical and unnecessary. Outbound investment from Australia would, therefore, not be required for product distribution purposes.

The online supply of high-value goods is growing rapidly in most Asian consumer markets. Alibaba is the world's largest retailer and is responsible for around 80 per cent of China's online retail sales. Australian SME exporters hoping to sell online are more likely to use existing online sales platforms than seek to establish their own.

However, this does not mean that Australian SMEs should have no investment presence in Asia. Developing trust through personal relationships is important in Asia, far more so than in American and European markets. Aspiring Australian exporters who adopt a fly-in, fly-out approach to pursuing opportunities in Asia are likely to be disappointed. A local presence in the market can deepen business relationships with distributors and other local support services.

Furthermore, provincial and national governments in Asia take a more positive view of foreign businesses if they assist in local economic development consistent with the governments' priorities. For example, the Chinese side in the Australia China Food Study, *Feeding the Future*, placed a high priority on gaining the benefits of Australian farming expertise in the development of agriculture in its poorer provinces.[9] Establishing a good reputation with governments in Asia by being willing to assist in some way with local economic development can be a wise strategy for Australian businesses.

Services exports provided in country

Australian SMEs seeking to provide services within Asian markets, such as advisory, architectural, urban development and health and aged-care services, cannot feasibly do so without a local presence in those countries. Services account for around 60 per cent of Australia's GDP and 80 per cent of Australian jobs, but only 20 per cent of the country's exports.[10] However, services exports *have* doubled over the past two decades and, in 2010, China overtook the US as Australia's largest services export market.

Australia's services exports are dominated by tourism and education, with much smaller contributions coming from financial, professional, information technology (IT) and health services.[11] Tourism and education services are overwhelmingly provided in the exporting country's domestic market, but count as exports because they earn foreign exchange income. Australian tourism operators can benefit from establishing a marketing presence in tourist-originating countries but are unlikely to invest in tourism infrastructure in those countries. Similarly, education providers are likely to see merit in establishing a local marketing presence in student source countries. Australian universities have been setting up campuses in Asia, with mixed success, and private training providers might do more of this in the future.

SMEs operating in the in-country service exporting industries, such as architectural, professional and health services, will require a strong local presence; these services cannot simply be generated in Australia and exported to Asia. Demand for these sorts of services in Asia is already massive and will continue to grow

strongly with the growth of the region's middle class. As Australia continues its transition from the end of the mining boom, government policy can be effective in facilitating investment by SME exporters providing in-country services in Asia. Efforts by Australian service providers to establish a presence in emerging markets can face resistance by the regulatory authorities in those markets. Restrictions on foreign investment in sensitive service industries remain in place and licensing processes can be opaque. These regulatory barriers increase the risk of Australian outbound investment in those markets.

Australia's outbound direct foreign investment

Three English-speaking, developed nations – the US, the UK and New Zealand – are currently the major destinations for Australia's outbound investment. In 2001, these three countries accounted for more than two-thirds of the stock of Australian outbound direct investment (see Table 1). This is now changing, with those three countries accounting for well under half the total in 2015 – the latest year for which official statistics are available.

TABLE 1
TOP 10 DESTINATIONS OF AUSTRALIA'S OUTBOUND DIRECT INVESTMENT, 2001 AND 2015

Outward FDI in 2001 (stocks)				Outward FDI in 2015 (stocks)			
		A$ billion	Share (%)			A$ billion	Share (%)
1	United States	107.4	46.7	1	United States	105.2	19.4
2	United Kingdom	36.6	15.9	2	United Kingdom	81.3	15.0
3	New Zealand	16.4	7.1	3	New Zealand	60.5	11.2
4	Hong Kong SAR	4.9	2.1	4	Singapore	21.2	3.9
5	Canada	3.6	1.6	5	Papua New Guinea	16.4	3.0
6	Singapore	2.1	0.9	6	Germany	14.8	2.7
7	Papua New Guinea	1.3	0.6	7	China	14.1	2.6
8	Germany	1.0	0.4	8	Canada	8.5	1.6
9	Indonesia	0.5	0.2	9	Bermuda	7.9	1.5
10	China	0.4	0.2	10	Netherlands	7.8	1.4
	Subtotal	174.3	75.8		Subtotal	337.8	62.3
	Total all countries	230.0	100.0		Total all countries	542.6	100.0
	ASEAN	*6.3*	*2.8*		*ASEAN*	*37.6*	*6.9*
	EU	*48.0*	*20.9*		*EU*	*111.8*	*20.6*

Source: Austrade (2016)[12]

Note: Data for FDI stocks for PNG and Germany are for 2013. No data was published for 2014 or 2015.

Although Australian outbound investment into China has grown in nominal terms from just A$400 million in 2001 to A$14 billion in 2015, China's share remains very low, at just 2.6 per cent of Australia's total outbound investment. Meanwhile, Australia's outbound investment into ASEAN countries has risen sharply, from A$6.3 billion to A$37.6 billion, lifting their share from 2.8 per cent to 6.9 per cent.

A more detailed analysis of outbound direct investment by Australia's 2000 largest companies, undertaken in 2015, confirmed these trends.[13] It found that one-third of Australia's top 2000 companies hold direct investments in an offshore market, the top five locations being New Zealand, the US, Britain, Singapore and Hong Kong. Australian manufacturing companies had invested in the greatest number of foreign companies of all sectors, followed by companies engaged in professional and financial services.

A mismatch between existing outbound investment and growth opportunities

Australian business development and job creation would benefit from greater outbound investment into the growth markets of Asia. Yet, only one of the top five destinations for Australian direct investment is in Asia, representing the continuation of a long-standing situation that is changing only slowly. This suggests that Australian businesses are more comfortable investing in English-speaking countries with familiar institutions and legal systems.

If Australia is to take full advantage of being in the right place at the right time – in the Asian region in the Asian century – it will need to integrate its economy more deeply into the rapidly growing economies of the region. This cannot be done through trading relationships alone. Considerations such as language, culture and familiarity with internal markets will require Australian businesses to invest directly in business operations in those countries. A fly-in, fly-out approach to business relationships in Asia will not work.

> "If Australia is to take full advantage of being in the right place at the right time – in the Asian region in the Asian century – it will need to integrate its economy more deeply into the rapidly growing economies of the region."

Yet, risk-averse Australian businesses – especially SMEs that lack knowledge about emerging and frontier Asian markets, government laws and regulations, and ways of doing business – will experience difficulty in making direct investments in those countries. These informational deficiencies constitute a market failure. SMEs typically do not have the wherewithal to navigate through complex and often opaque regulatory systems. Nor do they have the creditworthiness to attract private finance in their own right. These limitations help explain the lack of SME investment in Asian export markets outside of Singapore and Hong Kong. But these difficulties are not limited to SMEs; institutional investors in large, publicly listed corporations might not place a high value on regional expansion strategies of those businesses, given their inherent riskiness.

Australia's institutional settings

The two most relevant government agencies for facilitating trade and outbound investment from Australia are Austrade and the Export Finance and Insurance Corporation (EFIC). Both have undergone reviews in recent years, with the specific objective of ensuring they are able to support SMEs seeking to enter the rapidly growing markets of Asia.

Austrade

The Austrade review, initiated in 2010, produced a new operating model predicated on addressing market failure. Austrade has moved away from assisting SMEs that have been operating in the Australian market to become export ready and toward supporting export-ready businesses to operate in overseas markets.

As the Austrade review points out:

> "…market failure will be strongest in markets where governments play a significant role in the economy, where language and business culture can provide a barrier, where there is less openness of regulatory frameworks and transparency of business processes, where there are difficulties accessing distribution channels and commercial connections and where the value of the 'badge of government' is highest."[14]

As an outcome of the review, Austrade's geographic focus was shifted towards frontier and emerging markets, where Australian businesses would benefit most from government assistance. Austrade's presence was reduced in the mature markets of North America and Europe and increased in Asia and South America. Nevertheless, Austrade remains responsive to new opportunities, including in areas such as health and biotechnology. It has opened offices in Boston, Houston and the five landing-pad locations – Singapore, Shanghai, Berlin, San Francisco and Tehran – to assist Australian businesses to find new, high-tech opportunities.

> "Austrade has moved away from assisting SMEs that have been operating in the Australian market to become export ready and toward supporting export-ready businesses to operate in overseas markets."

Export Market Development Grants (EMDG) scheme

The EMDG scheme provides grants to SMEs seeking to promote their exports in overseas markets. Changes introduced in 2013 concentrated the scheme more heavily on East Asian, emerging and frontier markets, in line with Austrade's newfound emphasis on these markets. The 2013 changes reduced the number of years that grants can be claimed to five in the markets of Europe and North America, while increasing the number to eight in less-mature markets.

EFIC

A 2012 Productivity Commission review of EFIC recommended that it focus its support on SMEs and on instances of market failure. The Productivity Commission:

> "… found no evidence that market failures impede large firms from accessing financial services in its 2012 inquiry into export credit provided through the Export Finance and Insurance Corporation (EFIC). The Commission's recommendations in 2012 were focused on limiting EFIC's role to efficiently addressing the information-related market failures faced by newly exporting small and medium-sized enterprises."[15]

The Productivity Commission has pointed out that refinements to EFIC's mandate since the Commission's review have stopped short of ensuring EFIC's activities are limited to the role of addressing market failure. While EFIC is no longer permitted to support large-company involvement in onshore resource projects, it can still support large companies that are involved in major overseas resource projects. In 2014–15, large companies accounted for 40 per cent of the value of EFIC's business.[16] Consequently, the Productivity Commission has recommended that EFIC's role be confined solely to providing export finance to newly exporting SMEs.[17] EFIC has not adopted this recommendation: its four-year corporate plan for 2016–17 to 2019–20 targets an increase to more than 50 per cent of the *value* of its business with non-SMEs, notwithstanding a sharp increase in the *number* of SMEs it expects to support.[18]

"The case for new, outbound investment is stronger for Australian exporters of high-value agricultural and processed goods, such as premium-quality food and beverages, and in services delivered into Asian markets."

Conclusions

Outbound investment by Australian businesses can integrate them and the national economy more fully into the rapidly growing economies of Asia, taking advantage of Asia's burgeoning middle class and accelerating Australia's transition from the end of the mining boom. The case for new, outbound investment is stronger for Australian exporters of high-value agricultural and processed goods, such as premium-quality food and beverages, and in services delivered into Asian markets. Offshoring of manufacturing and back-office services is becoming less important, as the impact of relative wage costs on locational decisions declines in the Digital Age. Australian government policies for facilitating outbound investment should concentrate on SMEs seeking to invest in emerging Asian markets, where the prospective benefits flowing from such investment are large and market failure is more evident.

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3. The Asian opportunity

Andrew Parker

There has been a structural shift in the world economy. With Asia now representing 40 per cent of world gross domestic product, this chapter questions whether Australian business is investing enough in this region.

Andrew Parker is a Partner at PwC where he leads the Australian firm's Asia Practice. Mr Parker joined PwC in 1985, became a partner in 1999 and spent 12 years in PwC's London, Moscow and Jakarta offices. Mr Parker has had a long association with Asia; he has lived and worked in Indonesia, and was the leader of PwC's Asian telecoms industry team until 2012, a role he held for nearly 10 years.

He is a Director of China Matters, a Director of the Australia Indonesia Centre at Monash University, an Executive Committee Member of the Australia Japan Business Cooperation Committee and a member of the Advisory Board of the Asia Society. Mr Parker was the lead author of PwC's landmark report on Australia's lack of business investment in Asia, titled *Passing us by*,[1] and is a regular commentator in the media and presenter at forums on Asian trade and investment in Australia and Australian trade and investment in Asia.

Mr Parker has a Bachelor of Economics from Macquarie University in Sydney and is a Fellow at the Institute of Chartered Accountants.

Introduction

As a nation, we face very real challenges in finding new sources of growth that diversify our economic base, create more and better paid jobs for our children, and provide for an ageing population. If we don't, future generations will not enjoy the same lifestyles that we have grown accustomed to.

Most would agree that Asia's economic power is growing. But has the full extent of this growth actually sunk in?

There has been a structural shift in the world's economic centre of gravity. It is not a cyclical shift occasioned by the global financial crisis – a distinction that too few Australian firms have truly come to terms with.

The rise of Asia

Today Asia accounts for around 40 per cent of the world's gross domestic product (GDP), up from 25 per cent in 1990. Growing at over five per cent per annum, the region produces two-thirds of global growth.

In less than a decade and a half, four of the world's five biggest economies in purchasing power parity (PPP) terms will be in Asia: China, India, Japan and Indonesia.[2] The US will be the only non-Asian economy in the top five. By 2030 two-thirds of the world's middle class – a staggering 3.2 billion technologically enabled consumers – will live in a region that produces more than half of the world's economic output and is home to 21 of the world's 37 megacities.

China alone, in the midst of a difficult period of transition itself, produces one-third of the world's growth in total economic output and in 2016 added over US$700 billion to its GDP. To put this in context, that's around two-thirds of an Australian economy.

India, already the eighth largest economy in the world in nominal terms (third largest in PPP terms), is expected to climb past Brazil, the United Kingdom, France, Germany and Japan to take third place in the world ranking by 2030. The International Monetary Fund (IMF) calls India "the bright spot in the global landscape".[3] The country will have the largest workforce in the world within the next 15 years and among the youngest with half of its 1.2 billion citizens under 25 years old.

And let's not forget the ASEAN Economic Community (AEC) a little closer to home. With a population of 622 million, nearly half under the age of 30, the AEC is a US$2.6 trillion economy with growth rates of five per cent plus. ASEAN is collectively the third largest economy in Asia and in nominal terms, the seventh largest in the world.[4]

Australia, by comparison will not find growth as abundant at home. By 2030 we will have lost our status as a G20 economy. If we don't respond we will be putting ourselves on a slippery slope to global irrelevance.

The facts speak for themselves: our economy is slowing, our terms of trade are slipping, productivity growth is weak, our governments spend more than they raise from taxes, and we're looking down the barrel of a national debt approaching A$350 billion, or just over 18 per cent of GDP in 2018–19. While low by international standards, our debt is greater than at any other time in our history and double what it was in 2013.

On top of this, the global economic outlook remains sluggish, and demand for mineral commodities is flat. Our once-reliable strategy of digging up iron ore and coal and shipping it to Asia simply won't cut it anymore. So how much longer can Australia afford to ignore the rising economic success of our Asian neighbours?

Intra-Asian trade is the real opportunity

The industrial and economic landscapes of the world have changed irrevocably since the beginning of this century, and it is more than just a shift from West to East. The rise of Asian economies is leading to nodes of new growth throughout the world – both between advanced and emerging markets and within emerging markets themselves. The effect on companies from the developed world will continue to be profound.

Globalisation, fuelled by technology, is changing traditional business models and removing the protections historically offered by geography and borders. Australian companies are not only dealing with traditional competitors from developed markets – they will also face increasing competition from world-class businesses from emerging markets, including those in Asia. These competitors have significant advantages, bringing formidable scale, low cost bases, strong brands and innovation to the market.

"The rise of Asian economies is leading to nodes of new growth throughout the world – both between advanced and emerging markets and within emerging markets themselves.

Asian economies are becoming increasingly sophisticated and connected – both globally and within Asia itself. While trade between Asia and the US and EU is substantial, the real growth story is the booming level of trade between Asian countries themselves, driven by the region's growing middle class and the fragmentation of global supply chains.

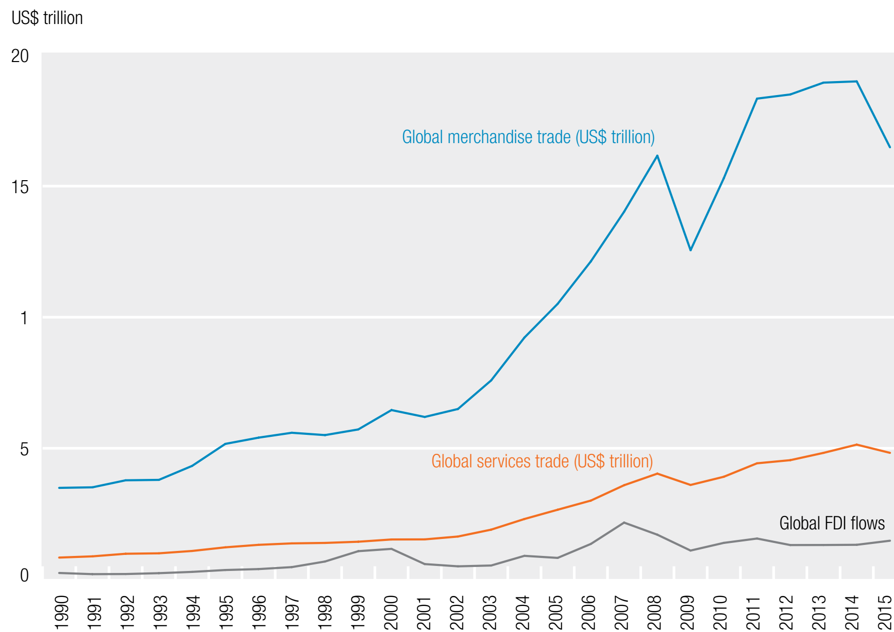
Intra-Asian trade reached US$2.8 trillion in 2015 and was only overshadowed by the EU, which recorded US$3.4 trillion of trade flows. Internal trade within the ASEAN economic community was over US$540 billion, or one-quarter of all trade in 2015, up from US$167 billion in 2000.

On the mergers and acquisitions front, ASEAN based acquirers accounted for US$7.9 billion of transactions involving an ASEAN based target between 2012 and 2015, the next largest buyer was Japan with US$2.6 billion, the US with US$2.2 billion and China with US$1.6 billion.

The opportunities are considerable, but so far remain generally overlooked by Australian businesses. Our existing relationships with Asia are largely built around our exports of bulk commodities, which alongside human capital are our predominant sources of competitive advantage.

Australia has done tremendously well over the last 25 years by exporting our commodities to Asia. Our agricultural products and mineral resources have benefited from economic growth in the region and fed a rapidly growing middle class.

FIGURE 1
GLOBAL TRADE AND FOREIGN DIRECT INVESTMENT FLOWS



Source: PwC modelling, UNCTAD 2015 World Investment Report, OECD statistics

In the same period, global trade in goods grew 4.7 times from US$3.5 trillion in 1990 to US$16.5 trillion in 2015, a compound annual growth rate of six per cent – all of that growth happened in the period before 2007 with trade in goods not growing at all in the last eight years. Trade in services though has done better and grew nearly six times from US$831 billion to US$4.8 trillion over the same period (see Figure 1) although growth has slowed since 2007.

The end of the resources investment boom means that the Australian economy must look to new growth drivers. The good news for Australia is that we are rebalancing growth back towards a greater reliance on our service sector at the same time as Asian countries, most notably China, are increasing consumption as the middle class consumer population expands.

> "The end of the resources investment boom means that the Australian economy must look to new growth drivers."

Trade in goods and our "exports" of education and tourism services will remain important elements of the Australian economy and our relationship with Asia.

But if Australia is to participate in the growing Asian consumer economy as more than just a farm, a quarry or a beach, we are going to have to engage and invest more in Asia's markets and businesses.

To be part of those markets, Australian firms will have to be where the consumers are – and that is increasingly in Asia.

Foreign direct investment in Asia – we've got a long way to go

And while we trade with Asia, we are not in Asia.

The low level of effective engagement by Australian businesses in Asia is evidenced by statistics about our foreign direct investment (FDI). While Asia ranks as Australia's largest export market, in fact six of our top 10 trading partners are in Asia, just 10.9 per cent of our total FDI stock in 2015 was in the region.

Our total outward stock of FDI sits at 32.4 per cent of GDP, which is right on the G20 average although below Canada and the UK and slightly ahead of the US. Our stock nearly doubled from A$280 billion at the end of 2005 to A$543 billion at the end of 2015. At the same time global outward FDI stocks also doubled from $US11.9 trillion in 2005 to US$24.9 trillion in 2015 suggesting that Australian companies have not been shy in investing outside of Australia.

But Australian businesses continue to focus their investment activities in lower growth markets. At the end of 2015, we had invested more in New Zealand (A$60.5 billion) – a country with a population of less than four and a half million and 2.5 per cent GDP growth – than we had in all ASEAN countries, China, Japan, India and Korea combined (A$59.1 billion).

To be fair there are some encouraging signs of change. A decade ago our investments in the Asian region were a meagre A$14.3 billion or 2.8 per cent of our stock of FDI at the end of 2005. But before we get too carried away, consider that Japan has invested at least US$20 billion into ASEAN alone in each of the last three years. The story with the EU is the same having invested US$24 billion in each of 2013 and 2014 and a further US$20 billion in 2015. Each of these investments is more than Australia's total stock of FDI in the entire Asian region at the end of 2015.

TABLE 1
AUSTRALIA'S OUTWARD DIRECT INVESTMENT BY COUNTRY

	Australia's FDI into country (AU$ billion) (2015)	Size of economy (US$ trillion) (GDP 2015)	Economic growth forecast
EU	$111.8	$16.2	1.7% by 2018
US	$105.2	$17.9	3% by 2018
New Zealand	$60.5	$168	~3% by 2018
ASEAN	$37.6	$2.6	4.8% by 2017
China	$14.1	$10.8	6.1% by 2018
India	$1.5	$2.0	7.5% by 2018
Korea	$0.7*	$1.3	3% by 2018
Japan	$0.5*	$4.1	0.8% by 2018

*2015 data unavailable therefore 2014 data has been used
Source: PwC report *Passing us by;* ABS statistics; PwC modelling

High-value goods and services are the new growth engine

As Asia's economies mature and consumption of products and services grow, there will be increased demand for the other things Australia is good at – clean, green and safe food and agriculture, tourism, education, and infrastructure. For example, the Asian Development Bank has said that ASEAN countries need to spend US$60 billion per year to meet infrastructure needs to 2025.

Our quality education system means we also have strong capabilities in service industries like accounting, legal, healthcare, engineering, architecture and financial services, to name a few. These can be the drivers of a new wave of growth for Australia in Asia. If the last 25 years has been about shipping our bulk commodities to Asia, the next 25 will be a story of consumption and services.

"If investing and doing business in Asia were simply 'too hard', then very few countries would be doing it successfully. But that's simply not the case."

And to some extent, the shift is already taking place. In each of the past two years, the total value of exports to China has declined, largely as a result of weaker commodity prices. But while the export of goods has fallen, the export of services has increased from A$7.1 billion in 2013 to A$9.8 billion in 2015. Our service exports to China now exceed the value of our iron ore exports to Korea and Japan combined.

International education and tourism are our third and fifth-largest exports, respectively. Together they generated export revenues of more than A$35 billion across the region in 2015. These sectors employ more than 500,000 Australians.

China is expected to become Australia's largest source of tourist arrivals, eclipsing New Zealand in 2017–18. China is already our largest market when measured by total expenditure. Chinese visitors in Australia will account for 43 per cent of the growth in arrivals and 60 per cent of the growth in visitor expenditure over the next decade, according to Austrade.

Overcoming the barriers of attitudes, knowledge, short-termism

The question that is often asked is: "Should we be in Asia?" But the real question is: "Can we afford not to be?"

If investing and doing business in Asia were simply "too hard", then very few countries would be doing it successfully. But that's simply not the case. The US, Europeans, China, Japan and Korea have all successfully invested across Asia to a much greater extent than Australia. Global brands from Europe and the US are also well established with strong local connections and partners. This suggests

there is something else holding Australian business back. Our research consistently indicates three main barriers: attitude, lack of cultural knowledge and short-termism.

Many Australian boards have strong preconceived views that it is difficult to do business in Asia. Among the key challenges they cite corruption, cultural differences, uneven playing fields, legal and non-tariff trade barriers as well as the near invisible web of relationships between government and business. In our experience, there is a consistent folklore that circulates in Australian business circles and permeates – and perpetuates – the discourse about the challenges of doing business in Asia.

> "Many Australian boards have strong preconceived views that it is difficult to do business in Asia. Among the key challenges they cite corruption, cultural differences, uneven playing fields, legal and non-tariff trade barriers as well as the near invisible web of relationships between government and business."

In addition to perceived difficulties and lack of knowledge, Australian boards struggle with short-termism when it comes to Asia. The fact is that doing business in the region can often require capital and operating expenditure that might not produce returns for years. But while this is just one factor among many that should be considered when making an investment case, it's one of the main hurdles.

There's a common belief among boards that this short-termism is driven by market analysts and fund managers, who demand short-term returns. There's also a strong belief – which is supported to some extent in reality – that analysts and fund managers see Asia as risky and long-term, and apply a valuation penalty to deals or market plays in the region.

It is right to say that there is risk attached to an Asian investment, and that risk does need to be valued. But the fact is that it will take time to become competitive in new markets, so a long-term view is essential. The important point for companies is that there needs to be a strong conviction to the strategy, a clear articulation of the strategy for investors, complete alignment between the board, chairman, CEO and management team and a well thought out risk management plan. It is vital that the risk management plan treats relationships as strategic assets of the business and they should be managed accordingly.

Another commonly cited problem is a perceived bias in the Australian taxation system against Australian investors owning shares in companies with significant foreign businesses. If an Australian resident company distributes foreign income in the form of a dividend to its Australian resident shareholders, they do not receive any offset for the tax paid in the foreign jurisdiction. As a consequence, they will pay tax at their marginal rate in contrast to a fully franked dividend that would provide a 30 per cent franking credit.

A 2009 report prepared by the then Secretary of the Treasury, Dr Ken Henry AC, commented: "The non-creditability of foreign taxes may increase the required return for offshore investment, discouraging such investment and encouraging a domestically focused investment focus."

The Henry Review[5] argued that the resulting tax bias may be beneficial from a national perspective because paying foreign taxes does not benefit the Australian Government revenue. The report went on to note that this view assumes that there is no spillover benefit from FDI and such investment was a substitute for, rather than a complement to, domestic investment.

An ANZ report published in 2015 *Winning the Away Game: Australia-based Global Companies and the Economy*[6] argues that a 20 per cent non-refundable tax credit for Australian resident shareholders receiving dividends from offshore sources would generate a substantial net economic benefit for Australia.

ANZ argues that the change would increase investment in Australian based companies with offshore businesses, contribute to increasing the number and depth of Australian based global companies and allow a solid base of investment in Asia to take advantage of free-trade agreements (FTAs) and the growth of Asia.

The ANZ report goes on to say that the proposed reform would contribute to the diversification of the Australian economy, create more high value jobs and better commercialisation of Australian research and development. According to ANZ, it would also create incentives for Australian companies and their foreign businesses to remain in the country and make Australia a more competitive business base for the future.

Notwithstanding this perceived bias, a number of Australian companies with substantial offshore operations have adopted pragmatic ways to deliver tax effective outcomes to their Australian shareholders by way of on-market share buy-backs.

The extent to which dividend imputation contributes to a "home bias" or not in investment decisions has been the subject of academic research and could be a topic that attracts further consideration from policymakers.

"It is right to say that there is risk attached to an Asian investment, and that risk does need to be valued. But the fact is that it will take time to become competitive in new markets, so a long-term view is essential."

In a recent PwC survey of 30 ASX 200 companies, we asked: "To what extent does Australia's dividend imputation system influence decisions about the company's plans to invest in Asia?" Only one respondent, from the financial services industry, said that the system was a "significant disincentive" and one other said it had "some influence".

This would suggest that the bigger issue is culture and our ability to operate in an Asian environment rather than the Australian taxation system.

Tapping our unrealised assets – people

Contrary to popular belief, Australia does in fact have the talent to succeed in Asia. We just aren't doing enough to foster, prepare and deploy it in the region.

A study by the Australian Human Rights Commission (AHRC) together with PwC, Westpac, Telstra and The University of Sydney reveals an overwhelming Anglo-Celtic dominance in Australian leadership across business, politics, government and civil society.

The report, *Leading for Change*,[7] finds 77 per cent of ASX 200 CEOs are from Anglo-Celtic cultural backgrounds. This is despite 28 per cent of our population having been born overseas.

Another study by the Australian Council of Learned Academies (ACOLA) paints the same picture, revealing an alarming disparity between Australia's demographic makeup and that of its corporate boardrooms.

ACOLA's report, *Australia's Diaspora Advantage: Realising the potential for building transnational business networks with Asia*[8] cites estimates from the Diversity Council that 17 per cent of people living and working in Australia claim Asian origin.

That's about four million people who have the cultural and language skills, business acumen, and contacts, to operate effectively in the region. Yet, it says, only four per cent of our top 200 publicly listed companies have directors of Asian descent. That's just eight companies.

And of the Australian's that do have the right skills for Asia, many simply don't work for Australian companies; only a small percentage of Australian firms have a presence in the region and the percentage of companies considering expanding into fast-growing Asian markets is low.

"Asian countries are seen as dynamic and entrepreneurial. Isn't that what the Australian business culture used to be known for?"

PwC modelling for a recent report titled *Our Diaspora's got talent*[9] predicts that by 2030 there will be 450,000 Australians living and working abroad in Asia, representing one-third of our total expatriate community, up from approximately one-fifth of the total today.

This group of Australian expatriates are somewhat of a "forgotten army" and along with our Asian diaspora, could provide the talent Australian firms say they need.

These globally connected professionals, who understand both life in Australia and the way business is done in the region, are a significant asset to Australian businesses that has been underutilised to date.

Asian countries are seen as dynamic and entrepreneurial. Isn't that what the Australian business culture used to be known for? So instead of lamenting the lack of talent, it's time we reconnected with our adventurous spirit and our willingness to have a go.

The people who can help are right in front of us.

A stark choice

The region will require immense investment in infrastructure and the implementation of anticipated improvements to political, economic, legal and social institutions in order to achieve its potential. So any projections of Asian success are not without risk.

But as one of only a few developed economies in the region, Australia is well positioned to help others and ourselves with rapid advances in technology, innovative ideas, and our concentration of talented people that are key drivers of economic growth.

"But as one of only a few developed economies in the region, Australia is well positioned to help others and ourselves with rapid advances in technology, innovative ideas, and our concentration of talented people that are key drivers of economic growth."

If all this sounds too hard we could accept the status quo. With economic growth expected to run in the two to three per cent range for the foreseeable future we will be alright. While that's well below our long-term trend growth rate of 3.3 per cent, we'll still do better than the major North American and European economies.

But it does leave us with a stark choice: accept a lower standard of living or leave our children with an even bigger debt burden.

One alternative is that we change the way we do business and take some calculated risks by stepping into Asia. To be sure, the operating environment is not straightforward, and the opportunities are not risk-free, but then growth is never a risk-free proposition.

And the biggest risk may very well be in doing nothing at all.

Endnotes

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4. Integrating Australian agriculture with global value chains

Professor Alice Woodhead,
Greg Earl, Dr Shane Zhang

As world food demand grows, Australian agriculture has an opportunity to rise to prominence in our economy. This chapter looks at the benefit afforded to Australian business through logistics and food distribution chains in Asia.

Professor Alice Woodhead leads the Agricultural value chains and food systems research at the University of Southern Queensland. She is board member of the Australian Association of Southeast Asian Nations (ASEAN) Council, a fellow of the Organisation for Economic Co-operation and Development (OECD), an award winning agricultural/social systems scientist and a farmer. As a food systems specialist, she has looked at the many challenges Australia faces in exporting commodities and value added products, such as exporting perishable food produce to Asia. Professor Woodhead has worked with the agriculture and rural sectors for over 25 years, both as a social scientist and through developing industry and natural resource management policy.

Greg Earl was the deputy editor, opinion editor, national affairs editor and Asia Pacific editor of *The Australian Financial Review*. He spent more than a decade as a reporter based in Jakarta, Tokyo and New York. He is a member of the Australia-ASEAN Council Board. He is researching a book about Australia and Asia.

Dr Shane Zhang is a Senior Lecturer at the University of Southern Queensland. He specialises in the economics of transport, particularly aviation and the Chinese economy. Dr Zhang has worked with the aviation and logistics sector in China and is an advocate for aviation sector reforms and liberalisations. He has published in leading transport journals such as *Transportation Research Part A: Policy and Practice and Journal of Transport Economics and Policy*, and leading industrial economics journals such as *International Journal of Industrial Organisation* and *Review of Industrial Organisation*.

Introduction

Across Asia, rapid urban growth is driving change in retail outlets and consumer purchasing. Asians are predicted to consume half the world's food by 2030 and

they are becoming "western urban", with shelves of ready packaged meats, cheese and imported fruit and vegetables increasingly purchased from supermarkets, rather than local wet markets. Increasing numbers of middle-class Asian consumers are preferentially purchasing premium chilled food from Australia and other western countries because it is perceived as being safe and high quality. Dairy, beef and premium fresh produce are in high demand and this is expected to grow. This presents opportunities for Australian agricultural business.

Deloitte and others have identified agribusiness as one of the five industry sectors that could provide the next growth wave in Australia after the mining boom. The firm says Australia's global comparative advantage is higher in agriculture than any other sector and over the next 20 years GDP growth potential in this sector will be matched only by tourism and gas production.[1]

Yet Australian businesses remain cautious, more inclined to invest in Europe, New Zealand and the United States, where economic growth is much lower. And while the Asian market provides untapped opportunities, it is important to acknowledge that this is a global market, and there is fierce global competition to enter the Asian markets. Indeed, establishing food products in Asian markets is more complicated than in Australian markets or in other developed countries' markets. Systemic failures in food distribution, from Asian entry port to retail outlet, are due to limited awareness of chilled food quality systems, regulatory enforcement failures and inadequate infrastructure.[2]

These failures are being exacerbated by rapid chaotic urbanisation, climatic change and traffic congestion.[3] While Asian consumers are keen to assimilate more western food into their culinary experience and move to fast food from wet markets, food scares have severely impacted on their confidence in chilled food. Urban Asian middle-class consumers need credible assurances that food is safe to eat when purchased from the refrigeration aisle of the thousands of new supermarkets across Asia.

The country or companies that will gain the most market share in Asia will do a lot more than sell food to importers at a food fair. For Australian companies to compete in these markets there needs to be deeper engagement in Asian business that includes managing, partnering or investing in food distribution infrastructure and services.

This is not a negative cost to bear, but rather an opportunity to diversify our expertise. Drake-Brockman noted in a paper for CEDA that the highest value in global value chains (GVCs) for manufacturing are now contributed by service inputs through R&D and the design phase, or at the logistics/distribution phase.[4] Australian firms could likewise leverage their expertise, experience, technology and supply chain connections.

Drake-Brockman points out that there are GVC opportunities not just for large businesses, but for small- and medium-sized enterprises (SMEs) delivering both services and products. Value adding includes the transport infrastructure; people training and quality control systems; and restaurants, hotels and supermarkets. So, Australian investment in delivering agriculture and food products to Asia could extend to investment in the region by large retailers, premium delicatessens, hotel chains, logistics and packaging companies.

"Australian investment in delivering agriculture and food products to Asia could extend to investment in the region by large retailers, premium delicatessens, hotel chains, logistics and packaging companies."

This chapter draws on Woodhead's systems thinking approach[5] to determine how and where to invest in systems that are defined by rapid population growth, as well as rapid changes in consumer purchasing power and expectations. It asks: how can Australia be a part of our neighbourhood's growth? This chapter argues that the time is right for Australia to integrate with Asian value chains – where some of the agricultural opportunities are. It puts forward a case for why it is imperative Australia invests in Asian food distribution, and how we could collectively miss the boat if we don't act now.

Part 1, discusses the investment models. Part 2 draws out the challenges of moving from commodities to value added produce and integration with the global agricultural value chain. Part 3 builds on the discussion about integration and highlights the movement to food logistics metropolises. Part IV concludes with a discussion about reducing investment risk through seamless interconnectivity and recommendations.

Part 1 – the investment landscape

The past 10 years have seen a substantial change in the make-up of Asian investment in Australia, with food production and processing becoming a much more important part of the overall investment. This has raised a question: is relying on Asian companies with existing distribution networks the best way to insert Australian agricultural output into the retail networks that service the rising Asian middle class?

To make export supply chains work more efficiently and safely, Australian investors might need to consider entering joint ventures with investors or developing alliances to offer services. Japanese companies started the shift towards food investment in Australia, although Chinese companies have since become more prominent, followed by some interesting new investment from Southeast Asia, including most recently the Philippines. This chapter identifies four basic outbound investment models for delivering Australian food products and aligned services to Asia, these are:

> "To make export supply chains work more efficiently and safely, Australian investors might need to consider entering joint ventures with investors or developing alliances to offer services."

- ONE: Remain a traditional efficient bulk exporter with only minimal offshore physical investment. This means being subject to global competition, and relying on good relationships with buyers to ensure preferential purchasing when there are gluts in commodities such as sugar. This approach does not capture value added in branded products and is vulnerable to price volatility.
- TWO: Develop a national champion along the lines that has occurred in New Zealand with dairy company Fonterra. Linfox Executive Chairman, Peter Fox has called for the creation of agribusiness national champions in Australia and also lamented the lack of patient investment capital in Australia to fund business expansion into Asia. Australian companies are coming up against competitors with much longer-term investment horizons.[6] However, Fonterra is coming under growing scrutiny in NZ; while it is using its market power to become an efficient milk producer, it is failing to develop global branding leadership.[7]

  Australia has too many different agriculture products, ownership structures, industry associations, and approaches to value added export for a national champion approach to be easily replicated. Nevertheless, mining entrepreneur Andrew Forrest's renewed efforts to develop a new, accepted Australian national brand through ASA100 may be a useful partial step down this path. Forrest says Australia's food marketing to China is confusing due to conflicting messages and logos.[8] However, a "national brand" is not supported by all the government agencies nor individual businesses, so it is likely Australia will continue to have a range of branded identities.

- THREE: Rely on inward Asian investment to put Australian products into supply chains, which would see both Australian and offshore processing. This foreign investment provides greater scope for Australian farmers to increase their own investment in production because they can be more confident they have access to markets. In a submission to the Treasury inquiry into Australia's investment framework, the Australian Food and Grocery Council said: "While Australia's pool of funds under management is the third largest in the world, Australian fund managers are generally not attracted to the long term returns but short term volatility of the agrifood sector. Foreign investors in the Australian agrifood sector are typically focused on business expansion and long term returns."[9]
- FOUR: Direct investment abroad in processing of raw commodities and logistics networks. While financial services constitute about one-third of Australian outward direct investment, manufacturing is second at 17 per cent, or A$95 billion, but transport and storage is much smaller at less than one per cent, or A$4 billion. Direct outward investment in manufacturing and transport has been noticeably higher in the past two years. How much of this investment is directed to agribusiness food supply chains in Asia is not clear, although anecdotal evidence suggests it is relatively small.

Brisbane-based company Fibre King is an example of direct investment from a food service company that has invested in Thailand. The company manufactures customised packaging equipment mostly for Australian and international food manufacturers. In 2012 the company shifted its manufacturing operations to an industrial park on Thailand's eastern seaboard mainly because the then high Australian dollar was undermining its global competitiveness. But it has maintained its design and marketing operations in Brisbane.

The 2005 Thailand-Australia free trade agreement was a key to deciding the location of Fibre King because much of the production still goes back to Australian clients, and both services and components come from Australia. Fibre King (which was trading in Thailand as Oryx Automation) is different to many manufacturers that move offshore to reduce labour costs in that it does not run a high volume standardised production line. Instead it typically produces high value customised automated packaging equipment for a client and then moves on to the next customised job. Fibre King sells its packaging equipment to global clients and now that it is based in Southeast Asia it is turning its attention to selling to regional manufacturers. But due to the fact much of its equipment is used by Australian food companies, its move to maintain its global competitiveness also contributes to the competitiveness of the Australian food companies.[10]

"Direct outward investment in manufacturing and transport has been noticeably higher in the past two years. How much of this investment is directed to agribusiness food supply chains in Asia is not clear."

In practice, over time most companies adopt a combination of models. Grain exporter CBH Ltd., a traditional bulk commodity exporter, has moved to direct investment in Asia through joint venture partnerships to integrate further into the branded food business in Asia. They established a joint venture based in Singapore with the large integrated Indonesian food producer Salim Group,

which operates food processer Indofood Sukses Makmur. CBH has invested about A$100 million in the joint venture (Interflour) since 2004. The business also diversified into a grain handling port in southern Vietnam, a private label bread making product, the animal feed industry and a malt making plant to supply the Vietnamese beer industry.

This joint venture, with processing in Asia, does not place Australian branded food in the hands of Asian consumers, but in a submission to a parliamentary inquiry in 2014, CBH said:

> "The partnership between CBH and Interflour is an exciting opportunity for West Australian grain growers to participate in the value chain and capture extra value created through the processing of their grain. The mills provide a greater degree of surety for the international demand of Australian wheat by displacing wheat previously supplied from the US, Canada, Indian sub-continent and Europe. In addition, the CBH Group is able to better convey clear market signals and unique feedback from international customers direct to growers."[11]

The servicing of the regional supply chains through developing transport, packaging, food technology and sale of expertise (in the form of operators) is critical to the distribution of food. The authors argue that direct investment in Australian food exports starts on the ground in Australia, such as the recently constructed Brisbane West Wellcamp airport in Toowoomba, which is targeting freight transport and food exports to Asia. It is strengthening regional Australia's access of Australian food exporters to Asian markets.

"The Australian government is investing A$60 million in a joint development project with Indonesia that aims to ease tensions over live cattle export issues and also build a more integrated supply chain for red meat into the Indonesian market."

Another model that is more diplomatic than investment, but has significant impacts on Australian companies' ability to integrate into global value chains, is economic diplomacy. The Australian government is investing A$60 million in a joint development project with Indonesia that aims to ease tensions over live cattle export issues and also build a more integrated supply chain for red meat into the Indonesian market.

The Indonesia-Australia Partnership on Food Security in the Red Meat and Cattle Sector was established in 2013. It was established after the temporary Australian ban on live cattle exports to Indonesia, the subsequent erratic changes in Indonesian live cattle quotas and debate about how the industries in the two countries could create a more stable supply chain.

Indonesia is pushing for more in-country breeding and processing. The largely aid-funded Partnership will run until 2024 with the intention of helping Indonesia develop its domestic industry while ensuring Australian product maintains a competitive role in meeting the country's import needs. By 2016 more than A$15 million had been committed to programs in areas such as breeding, transport and logistics, processing and skills development. Planned new programs include a proof-of-concept study to determine the feasibility and viability of a bonded logistics zone for cattle and beef processing in Indonesia and an investigation into the existing logistics chain for the supply of cattle from Australia to smallholder farms in Indonesia.

A separate public-private partnership has been established to examine different models for cattle breeding in Indonesia with Australian assistance. This program is tailored to suit the unique challenges of the Indonesian meat trade but may provide a model for using Australian development aid to improve food security procedures in other countries that are long term markets for food export, thus opening the doors for other food sector investments.

Part 2 – challenges of investing in integration

Australia is known as an exporter of commodities such as wheat, beef, sugar and more recently chickpeas. While commodities are differentiated, for example by quality grading, the commodity producers tend to be less integrated into GVCs than producers that take the next step and process their produce. Generally, an agricultural commodity producer will sell to an export agent or a buyer's cooperative, with destination unknown. A few growers do follow their products through the supply chain, engage with buyers and visit destination countries and meet consumers. Conversely, a few commodity buyers visit Australian farms.

Selling premium produce – particularly high value added protein foods, fresh fruit and vegetables – necessitates a different approach to selling commodities. It requires a deeper understanding of the destination and the customer. However, as with the investment models, there is not one model that defines producers' engagement with global value chains. Rather, a range of models have evolved that are partly in response to the produce, depending on whether it is fresh and perishable or dried. For example, in the beef sector several companies operate a hybrid model where they produce both commodity beef and branded produce for domestic and international markets. The main difference is that the premium branded produce uses its place of origin and sometimes the brand to provide a connection between the grower and the customer.

> "Selling premium produce – particularly high value added protein foods, fresh fruit and vegetables – necessitates a different approach to selling commodities."

Asian customers and consumers are buying premium, branded Australian produce for quality assurance and traceability as well as olfactory traits, juiciness, flavour, texture etc.[12] This is driven partly by quality, but there is also concern across Asia – particularly in China – about the use of pesticides, water quality and adulteration of food, such as injecting meat with red dyes. Consumers are looking for a guarantee of food safety, and the origin is important. The cow that produced the milk, the farmer that raised the calf, and so forth. Australian origin, at the moment, provides Asian consumers with confidence in the safety and quality of the product.

Understanding the value add challenge

The importance of transitioning from a commodity focus to a focus on premium chilled, fresh and value added foods may be difficult to understand; a brief understanding of Australian GDP is helpful in highlighting this importance. Australian agriculture contributed approximately three per cent to GDP in 2014. Once value added processes and aligned services are included, agriculture is contributing about 12 per cent of GDP (see Table 1).[13]

TABLE 1
COMPARISON OF FARM GATE AND MANUFACTURING DATA

	A$ billion (2014)	Australian GDP (per cent)
Total GDP	1458.68	
Agriculture	44.3	3
Food and fibre manufacturing	177.2	12

Source: National Farmers Federation Farm Facts: 2014

At the farm gate Queensland agriculture contributes about A$14.7 billion, accounts for 25 per cent of national agricultural production, employs 90,000 and exports A$5.4 billion.[14] Over 300,000 people are employed in agriculture in Australia, the value adding sector (food manufacturing and processing, distribution and retail) employs 1.6 million.[15] According to the National Farmers' Federation (NFF), when value adding is taken into account, agriculture's contribution to the GDP averages out at around 12 per cent (or A$155 billion). However, Queensland's value adding accounts for only a small portion of Queensland agribusiness production (A$3 billion).

It is reasonable to ask why Queensland – and Western Australia is another example – with their vast areas of agricultural land, are not also food manufacturing centres. The answer is somewhat historical, settlement in 19th and 20th century Australia was in the southern states. Victoria had a large population that could both support manufacturing and consume the produce, along with fertile agricultural regions. Victoria currently claims to produce nearly 50 per cent of Australia's processed foods.[16]

In the 21st century our population is more dispersed across the east coast and our markets are global. Yet in Queensland and Western Australia, there is an evident "commodity culture" rather than "food processing" and "value adding" culture. The traditional commodity business model is considered safer, simpler and easier than exporting value added differentiated products. However, it may be sub-optimal for Queensland communities because it means the economic and employment benefits of value adding are mostly realised interstate or overseas.

Where these commodity states have developed shelf ready products (such as horticulture) the focus has been primarily on domestic markets, which given our small population, offer limited opportunities for new businesses. Indeed our domestic markets are saturated. Asian fresh fruit and vegetable exports therefore provide an opportunity for the commodity states to diversify production by creating premium value added fresh and chilled products.

Australian food products are already achieving substantial premiums in Asian markets.

One may then expect other businesses to enthusiastically grasp the opportunity. However, many in the agricultural and food sectors are cautious about developing new products and expanding premium exports. According to the Australian Food and Grocery Council, two issues continue to define our lack of competitiveness: logistics and labour.[17] But, given that much of our expertise (and success) is in commodities, discussions with agricultural businesses have revealed these concerns:

- Risk and uncertainty about how to start and how to raise finance to diversify, develop products and manage quality in Asian supply chains.[18]
- Limitations of Australian manufacturing infrastructure, technology, export expertise and investment capital.
- "Try fails": Many agribusinesses have attempted exporting fresh fruit and vegetables and they have lost money. Reasons range from lack of preparation, to bio-security, customs, red tape, failure of distributors to deliver on predicted sales and fluctuations in exchange rates.
- Age: Agribusiness has been unpopular, with fewer younger farmers or business people entering the sector. Older producers don't want to take the financial risk or allocate the time needed to develop a new business.

What is necessary to make food processing and logistics work for producers and the food and service industries? How can ownership, management, collaboration and information sharing integrate regional Australia into GVCs; attract industry and investors; accelerate innovation and ensure businesses can consistently produce high quality products at globally competitive costs?

Clearly there is a need to reduce the risk by providing safer export pathways, building export expertise and creating stronger feedback loops. An integral aspect of the successful development of a food export business is to understand what types of businesses, business models and value-adding facilities and services are optimal. This includes considering the relative benefits of a food processing industrial park and food clusters.

Multi-stakeholder platforms, food clusters and a "food metropolis" are all emerging as solutions to reducing labour and logistics costs and increasing innovation and knowledge sharing. They can provide a full suite of research and development, processing and business services along with mobile equipment to enable entrepreneurs and start-ups to invest in global value chains.

In the simplest form these multi-stakeholder platforms provide the resources for interaction among different stakeholders.[19] By reviewing options for facility placement in or near agricultural production areas a strategic export production and logistics setup can be achieved vs ad hoc geographically dispersed, uncoordinated development.

Meeting the Asian demand for premium chilled foods

Across Asia, as consumers' disposable income grows and they become more urbanised, they change their diets and their shopping habits.[20] They move from wet markets to supermarkets and develop an appetite for both fast foods and high-end meats, fruits and vegetables, and Australian fruit and meat is a favourite. These products need to be chilled, not frozen. Chilled food, sometimes referred to as perishable produce, requires careful quality control and monitoring across the entire supply chain to avoid costly spoilage and customer dissatisfaction. Each chilled product requires its own temperature (Apples 0°C, Meat –2°C, Pears and Strawberries –0.6°C, Seafood –17.8°C) and they like it within a degree Celsius of tolerance.

Frozen food is easier to manage because the temperature tolerance is greater. The art of cold chain logistics is, therefore, to achieve an integrated system and process where a wide range of perishable products are kept under a controlled cold environment from suppliers to end consumers.

The main causes of disruptions to cold chains are failure to maintain this temperature. The reason for disruptions are many, and include: inadequate infrastructure, complexity of interaction of chain members, long transport distances, traffic congestion, transport mode changes, fluctuations in demand, lack of standardisation of traceability systems, ineffective transport/storage technologies, absence of refrigerated facilities, lack of managerial skills, ignorant handlers, unskilled staff and misunderstandings, cultural differences, and so forth. Firms can also be exposed to operational and financial risks by unplanned and unexpected events that disrupt the normal flow of goods within a supply chain. In a review of China's cold chains, Zhang and Woodhead concluded that chilled food cannot be guaranteed to arrive in a safe and edible condition.[21]

> "Firms can also be exposed to operational and financial risks by unplanned and unexpected events that disrupt the normal flow of goods within a supply chain."

The growth in cold chains is evident across Asia. For example, in 2008 China had about 15 million cubic metres, by 2014 this had increased to 88.42. The number of refrigerated vehicles was 4290 in 2007, and by 2015 there were more than 50,000. It is expected that this industry would be worth CNY¥470 billion (US$68.18 billion) by 2017.

However, compared with developed countries, the capacity of refrigerated warehouses and the number of refrigerated trucks are still relatively small, especially in Central and West China. This resulted in 90 per cent of meat products, 80 per cent of aquatic products, and the majority of dairy and bean products being transported and sold without using any refrigerated equipment and outside the cold chain system. In fact, the number of refrigerated trucks only accounts for 0.42 per cent of the total number of freight vehicles, while in Germany it is about two to three per cent.[22]

In countries where the cold chain is underdeveloped (most of Asia and the developing world), there are opportunities for Australian logistics companies to take a leadership role in creating channels and developing skills within the country to enable the expansion of a wide range of chilled food distribution systems. Indeed, integration of Australian value chains into regional and global value chains – particularly with Asian distribution systems – is critical for the growth of premium food markets, which are generally chilled foods. Developing cold chain systems will benefit Asia's fresh food producers, especially the fruit and vegetable famers who are also constrained in their ability to export and service their growing urban populations.

Part 3 – challenges of investing in food, logistics and services

There is an opportunity now to accelerate growth by supporting companies so that they may expand and invest in Australia and Asia. Food clusters (where companies are grouped together to enable greater utilisation of resources and services) are emerging as solutions that can accelerate growth, investment and connectivity with markets and consumers.

Traditional food clusters tended to have a local rather than industrial/export focus. But in the 21st century, food and logistics metropolises are geographically aligning intensive agriculture, e.g. hydroponics, dairy, chicken and fish farms with food manufacturing, services and logistics. Interconnectivity includes the integration of transport logistics and services, across export destinations. A food cluster approach aims to streamline business activities across regions and countries by:

- Enabling agribusinesses to reduce capital investment through sharing processing, packaging and labelling facilities either at a fixed site or by a mobile processing and packaging unit; and
- Creating an environment for symbiotic relationships between the food service sector, processors, exporters and so forth.

Interviews conducted by Woodhead[23] into efficiency drivers for food manufactures indicated that decisions on food processing locations are based on:

- Access to produce;
- Logistics interconnectivity;
- Access to domestic and international markets;
- Skilled labour;
- Local and state government support including incentives and efficiency; and
- New products, including entrepreneurs and start-ups.

According to Horton *et al*,[24] many attempts to link research with development have failed due to "a focus on the supply of innovations, rather than on the demand for new products, processes, or institutional arrange¬ments".

Asian countries are developing metropolises that are themed either around food or logistics, but serve the same goal of accelerating and encouraging innovation through efficient, economical centres for food manufacturing and distribution that are highly responsive to customer demands.

Aerotropolises, for example, are vast clusters of airport-linked business parks, industrial parks, logistics parks and multimodal transport services that may extend up to 20 miles from the airport along major arterials. Zhengzhou in East Central China is identified as an emerging aerotropolis, and a point of entry for Australian exports due to its strategic location, transport connectivity, supportive customs and quarantine policies, and reliable cold chain infrastructures.[25]

> "Asian countries are developing metropolises that are themed either around food or logistics, but serve the same goal of accelerating and encouraging innovation."

Foodpolis is a Korean development that takes this idea of a food commodity cluster; located in the city of Iksan, it is a R&D-driven and export-oriented food industry complex. FoodInnopolis is Thailand's R&D and food innovation solution. It provides resources to support the manufacturing sector including tax exemptions and co-investment policies that encourage international investment in the food manufacturing centre.

A commercial food processing and innovation metropolis, with state of the art infrastructure that combines manufacturing, service and logistics companies can reduce business and transport costs, and importantly, it can increase efficiency and manufacturing and food distribution networks if the metropolis integrates with global value chains. For example, Toowoomba in Southern Queensland began the journey with the development of freight flights from Toowoomba to Asia. The first flight from Wellcamp Airport to Hong Kong was made on 23 November 2015 and carried 75 tonnes of cargo including chilled beef, organic chicken, mangoes, pecan nuts, lettuce, grains and some heavy machinery.

On 11 November 2016, Brisbane West Wellcamp was officially designated an international airport. On 22 November Cathay Pacific began a weekly freight service between Wellcamp and Hong Kong. Wagners Global Services Chairman and owner-operator of Brisbane West Wellcamp Airport, John Wagner the says: "Fresh produce is now flying out from the airport, and the quantity is growing, but the alignment of the inland rail, truck and airport services is critical to accelerate growth and to keep Australia competitive".

The next stage for Southern Queensland is to create seamless chains by creating the right environment for food processing and services near the airport and to integrate with other metropolises in Asia.

Part 4 – moving towards seamless connectivity

Australia needs to integrate into global markets in order to reduce risk and entry barriers to potentially lucrative Asian food markets. To achieve integration Australia needs to invest in these markets, particularly in food distribution. With international logistics and food production, Toowoomba and other areas of regional Australia can become food and logistics metropolises.

However, to make this happen, firstly Australia needs to adopt a strategy to put food processing in major regional centres – close to food production – rather than in cities. Secondly, Australia needs to develop intensive agriculture systems of food processing in these new "food metropolises", that produce premium fresh and chilled foods that are targeted at the Asian markets.

"Australia needs to integrate into global markets in order to reduce risk and entry barriers to potentially lucrative Asian food markets."

One could argue that without intervention, market forces and consumer demand will create the environment for the growth of food manufacturing and integration into global value chains over time. However, there is a risk that Australia will miss the opportunity to become a preferred premium food provider and remain a commodity producer, subject to pricing based on global production and markets rather than branded differentiated products.

However, these opportunities involve social and market systems that are evolving faster than the development of infrastructure, cold chain logistics, regulations and human resources. Australian business may have to think more about investment in the services side of the supply and strategic alignments.

For example, one emerging opportunity in our neighbourhood is the move towards economic integration in Southeast Asia. The 10 country ASEAN group has an average growth rate of over five per cent – and accounts for almost 15 per cent of Australia's trade. It is moving towards an integrated regional economy, the AEC, that will drive regulatory reform, and in doing so, enhance opportunities for integration of Australian value chains with ASEAN. According to the report, *Why ASEAN Why Now*, intra-ASEAN trade accounts for 24 per cent of ASEAN trade and the growth in regional value chains is a key driver for increasing integration and the opportunities for trade across the region will also increase.[26]

Australian companies and governments need to be looking more broadly at providing quality services to emerging Asian customers, the new middle class, by enhancing the security and safety of branded food products. The construction of an international airport at Toowoomba in the heart of a major traditional agriculture production region is an example of new thinking about how to invest in an Asian supply chain in Australia.

Given that cold storage facilities are underinvested in Asia, there is a major area of opportunity for investment and services supply. As we create the infrastructure, the reality of seamless connectivity will mean Australian businesses can create and prepare meals today in Toowoomba for consumption in Asian homes tomorrow.

Unlike some other growth sectors in Asia, Australia has a long standing natural comparative advantage in producing basic fresh food and more recently a growing reputation for producing safe and clean food. Australia also has a long standing relationship with our Asian neighbours through aid programs such as ACIAR, where we have helped our neighbours to improve their agricultural endeavours.

But looking to the future, food distribution systems and cold chains are the core of modern trade. The expected rapid growth of Asia's cold food storage sector offers particular opportunities for developing and developed countries, as does the creation of new fresh and chilled products. Finding better ways to connect Australia's natural product advantages and expertise with emerging global businesses in Asia will be critical to future contribution of the agrifood sector to economic growth.

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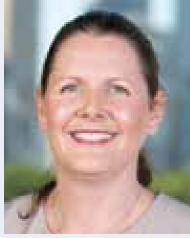
5. De-risking Asia

Megan Mulia

Conducting business in Asia requires Australian companies to consider multiple areas of risk. This chapter uses case studies to highlight three particularly significant areas of risk that should be taken into account when considering an expansion into Asia: political risk, cultural risk and brand risk.



Megan Mulia is Director, Research and Information, at Asialink Business. She has 20 years' experience in the strategic management of market intelligence, business information and research. She was based in Asia for 14 years, managing content and research for firms such as Factiva, Thomson Reuters, and PwC, and is able to bring a unique perspective on the information requirements of companies operating in the region.

Prior to joining Asialink Business, she worked with KPMG Singapore as part of its government-supported Institutes initiative to drive the business advisory and accountancy sector in the broader Asian region, through thought leadership and C-level stakeholder engagement. Ms Mulia managed a specialist team to deliver 30 major research initiatives over a two-year period.

She currently leads the research function at Asialink Business and is responsible for developing content such as Country Starter Packs, and various research and thought leadership reports including *Growing Knowledge Economies* and *Australia's Jobs Future: The Rise of Asia and the Service Opportunity*.

Introduction

All business involves risk, but doing business in Asia requires Australian companies to consider multiple areas of additional risk. With the right research and knowledge, these risks can be mitigated or even overcome. But why take on the risk of doing business in Asia at all? The answer is simple: huge rewards. For businesses that put in the time and effort to do their homework, the rewards that Asia can offer are significant. A range of steps can be taken to reduce the level of risk in the decision to expand into Asia. These include: effectively identifying and managing political and economic risks, considering appropriate business structures to transfer elements of risk, and considering cultural practices among others.

These risks can be successfully mitigated by businesses that make the effort to tune into the political environment they operate in, focus on garnering cultural intelligence and make a long-term commitment to doing business in Asia.

Political risk

Broadly speaking political risk derives from government decisions and the stability of a political system, both of which can impact on the value of a company and its long-term planning. Politics has the power to move markets, but as analysts point out, there is no one-size-fits-all model for assessing it.[1]

Political risk can involve multiple variables. A 2015 StrategicRISK study, for instance, found that the regulatory and legal minefield was the top political concern for risk managers in the Asia-Pacific region.[2] Adverse legal and regulatory changes topped the list of concerns, followed closely by terrorism and licence cancellation or amendment.

Businesses involved in the study reported that the most commonly used tool to mitigate political risk was a thorough political and economic risk analysis. This was closely followed by engaging in a joint venture or alliance with a local company, or engaging with a government body in the host country.

However, the study noted that "the results for mitigation were spread fairly evenly across the tools and mechanisms, suggesting there is no one-size fits-all approach to mitigating political risks".[3]

Similarly, Business Monitor International's Country Risk Index evaluates the level of political stability, economic outlook and operational barriers to doing business.[4] By closely monitoring developments in various countries, the index provides a measure of the pertinent risks that businesses should take into account when considering operating in Asia. Countries with a higher score present less of a risk, as highlighted below.

TABLE 1
RISK INDEX TABLE: SOUTH EAST ASIA

	Short term		Long term		Operational country	
	political	economic	political	economic	risk	risk
Singapore	94.8	76.0	80.6	75.1	82.3	82.2
Malaysia	76.9	74.6	66.7	71.2	68.7	71.8
Philippines	66.3	74.6	62.8	71.5	48.7	62.7
Indonesia	72.9	67.5	60.0	67.9	52.6	62.6
Regional average	**77.7**	**73.2**	**67.5**	**71.4**	**63.1**	**69.8**
Global average	**64.0**	**51.1**	**61.3**	**52.1**	**49.8**	**54.7**

Source: BMI, October 2016

TABLE 2
RISK INDEX TABLE: NORTH ASIA

	Short term		Long term		Operational country	
	political	economic	political	economic	risk	risk
Hong Kong	81.0	80.0	70.9	76.1	81.6	78.7
South Korea	79.6	81.7	84.2	82.9	69.1	78.1
Taiwan	74.6	79.4	73.4	76.7	74.2	75.3
China	80.2	75.2	62.9	76.6	56.2	67.7
Mongolia	61.7	40.4	67.7	40.0	49.5	51.2
North Korea	67.7	27.9	55.2	28.4	35.4	41.7
Regional average	**74.1**	**64.1**	**69.1**	**63.5**	**61.0**	**65.5**
Global average	**64.2**	**50.0**	**61.2**	**52.8**	**49.9**	**54.7**

Source: BMI, October 2016

TABLE 3
RISK INDEX TABLE: SOUTH ASIA

	Short term		Long term		Operational country	
	political	economic	political	economic	risk	risk
India	77.7	67.5	71.9	65.3	46.2	62.5
Sri Lanka	71.5	49.0	62.2	52.9	52.6	57.2
Bangladesh	61.0	66.7	62.6	62.5	38.6	55.5
Pakistan	50.8	55.2	53.7	54.6	35.7	48.3
Bhutan	61.0	57.1	51.0	39.3	52.4	50.6
Nepal	43.1	44.6	49.5	45.9	37.6	42.1
Regional average	**60.9**	**56.7**	**58.5**	**53.4**	**43.9**	**52.7**
Global average	**64.0**	**51.1**	**61.3**	**52.1**	**49.8**	**54.7**

Source: BMI, October 2016

However, businesses need to ensure they are considering political risks beyond just the broad macroeconomic data. For example, John Russell, Managing Director of North Head, a leading strategic communications and public affairs consultancy headquartered in Beijing, has been in China for more than a decade and is acutely aware of keeping an eye on government affairs.

He told Asialink Business: "You have to fit in with the broad objectives of what the government is trying to do, and if you work to the rhythm of the economy and its development, whether it's green tech or the growth of healthcare and education services; if you're fitting into the priorities of the government and economy, you're running with the tide and have more opportunities. If you're trying to do it without understanding what's happening with the broad market direction you can be caught out badly. This is not a market for carpet baggers. Due diligence and a sound business plan set genuine players apart from those chasing a quick buck."[5]

> "Businesses need to ensure they are considering political risks beyond just the broad macroeconomic data."

In the wake of Donald Trump's presidential victory in the US, geo-political uncertainty is rife, including in the Asian region. Companies operating in unstable environments would be wise to factor in additional costs to mitigate political risks.

The StrategicRisk study quotes Marriott International Director of Global Safety and Security, Danny Chan who says building the right connections with government as well as understanding local government is crucial to being across local conditions: "Transferring risk by going into a joint venture, or better understanding the new markets by engaging the local government, would certainly reduce the level of risk going into a new market."[6]

A reliable joint venture partner was a great advantage for GreenCo Water, which manufactures in Thailand, another country where political unrest can add uncertainty, potentially increasing costs.[7] When CEO Simon McMahon and his business partners decided to manufacture their PAK FLAT water tank in Thailand, they had concerns about the political risks they might encounter, but he had a longstanding relationship with Thai manufacturer Srithai Superware, who assured him that political unrest and military coups do not really impact business. McMahon said, "Yes, there were protests going on but the factory was running fine and goods could get to the port easily."

Both sides of Thai politics support foreign investment and international trade, so even if there was a sudden change of government, foreign businesses were unlikely to be affected. McMahon advises treating political risk just like other types of risk – account for it and manage it.

While he and the GreenCo Water team remain confident that risks from political unrest and natural disasters can be successfully managed, they have nonetheless set up contingency plans for worst-case scenarios. Their Thai partner has helped them identify a manufacturer in a third country who can take over production temporarily in the event that production is halted in Thailand, ensuring that GreenCo Water can still fulfil retailers' orders.

GreenCo Water's journey from product development to overseas production and importation into Australian stores has been made easier by working with a reputable partner. The joint venture with Srithai Superware is going strong and with production conveniently located near some of the fastest-growing markets in the world, GreenCo is considering expanding sales into Indonesia and the world's second-largest economy, China.

Accenture Finance and Risk Services Senior Managing Director, Steve Culp suggests a three-step process[8] to enable companies to identify political risk, measure its potential impact and determine the best method to manage it.

The first step is to identify the main political risks by building scenarios based on the key question: "How can political actors or conditions directly affect our objectives?"

In the second stage, risk managers assess and quantify the potential impact of each scenario on the business. Using these metrics, risk managers can assess whether the risk level surpasses the organisation's risk appetite or tolerance.

"Perhaps the biggest political risk is the risk of oversight. The failure to anticipate major political events... can present a picture of economic health and development while hiding underlying political and social tensions."

Then, once risks have been identified and measured, an effective system for active political risk management can be put in place, mapping potential risk management methods against the priority risks.

He says organisations can gain significant benefits from managing political risk – but they ignore this risk at their peril. The good news is that effective management of political risk "can enable companies to tap new revenue streams through access to markets and joint ventures that, without careful management, might seem too risky".

Perhaps the biggest political risk is the risk of oversight. The failure to anticipate major political events is in part a result of over reliance on macro data that can present a picture of economic health and development while hiding underlying political and social tensions. GDP growth rates, investment flows and the longevity of government can only ever tell one part of a nation's story. It's worth noting that underlying turmoil can have real implications for markets.[9]

The recent case of Crown Casino employees detained in China, amid reports that authorities are preparing to press charges on alleged gambling crimes, received significant media attention in October 2016. Three Australians were among the 18 sales and marketing executives arrested. While one employee has now been released on bail the others remain under investigation for violating strict laws that prohibit direct marketing of casinos to large groups in China. With China's anti-corruption crackdown reaching into the gaming industry, the Crown employees could face 10 years in prison.

Crown saw its share price tumble in the wake of the arrests. Even large companies can run afoul of the law if political risk is not taken into account – especially in a country like China, where the political framework is different to Australia's.

Cultural risk

Cultural awareness is often dismissed as a "soft" skill that is not as important as, say, understanding the regulatory framework of another country. But falling into the trap of dismissing the importance of garnering cultural intelligence can be the difference between business success and failure.

In 2012 the Federal Government White Paper, *The Asian Century*, identified the need for a better educated, Asia-savvy workforce. In the same year, Asialink established a taskforce to examine ways in which Australia could be at the forefront of creating an Asia capable workforce. It set out 11 capabilities critical for organisations and individuals in a national strategy to build "Asia-literacy". The absence or underdevelopment of these capabilities were "one of the biggest impediments to realising the Asian opportunity", the taskforce found.[10]

Unless local cultures drive business models, foreign businesses risk failure and the costs associated with failure in a foreign market can be significant: on average, international retailers absorb seven years of losses before they shut down or sell their operations to a local competitor.[11]

Consumer attitudes and behaviours are highly influenced by culture. So when a company moves into a new market, business models should be modified to reflect local preferences, customs, and habits. For example, changes should be made to product and service offerings, pricing, and marketing.

The one-size-fits-all approach to international business is flawed. International success requires "Glocalisation" – the interface of globalisation and localisation. Globalisation involves standardised worldwide processes, products, and services. Localisation involves processes and product offerings tailored to meet specific local markets. Glocalisation involves the integration of local features and global ideas, products, or processes. Glocalisation recognises that economic synergies are limited by deeply ingrained cultural systems resistant to change.[12]

"Unless local cultures drive business models, foreign businesses risk failure and the costs associated with failure in a foreign market can be significant: on average, international retailers absorb seven years of losses before they shut down or sell their operations to a local competitor."

Andrew Davies is CEO of Changing Space,[13] which handles the distribution of premium Australian products such as olive oil, nuts, muesli, coffee and chocolate to both the Japanese food and beverage and retail sectors. It also brokers the import of Japanese Agricultural System-certified raw ingredients. On a trip to Japan in 2012 Davies noticed a lack of Australian products in Japanese stores outside of multinational retailers, and with his Japanese business partner set about filling the gap.

Australians looking to sell their products in Japan need to take into consideration the sensibilities of Japanese consumers. For one thing, appearance is very important. According to Davies, “the Japanese often eat with their eyes”, so packaging and how a product is presented is of the utmost importance. Japanese consumers will notice imperfections that others may not. One of the products Changing Space distributes in Japan had a small problem with its packaging – something that was never noticed by consumers elsewhere, but immediately picked up by the Japanese. “If there is even the slightest thing wrong with it, Japanese consumers will send it back,” says Davies.

Cultural barriers don’t only occur at the customer interface. International business success also requires an in-depth understanding of local business customs. Without a full appreciation of how business is done in a foreign market – including economic, political, regulatory, and cultural influences – new entrants can quickly find themselves on the back foot with stakeholders.

Take China for example, where trusted relationships are everything. Business is done through sharing stories and information of a surprisingly personal nature. It is all about building a relationship, an essential part of doing business in China. The Chinese call it *guanxi* (关系). Often translated as “connections”, “relationships” or “networks”, none of these terms do justice to the fundamental and complex concept of *guanxi* and its central role in Chinese culture.

> “Without a full appreciation of how business is done in a foreign market – including economic, political, regulatory, and cultural influences – new entrants can quickly find themselves on the back foot with stakeholders.”

Guanxi can be used to describe a network of contacts, which an individual can call upon when something needs to be done, which they can exert influence through on behalf of another. These networks can have a direct impact on conducting business in China, including market expansion and sales growth.

Australian businesses might understandably struggle to integrate *guanxi* into their business practices. The key is to remain diligent and be aware that the reciprocal nature of *guanxi* dictates an informal obligation to “return the favour”.[14]

Failure to understand local cultural practices within the business setting has often forced Australian businesses to learn the hard way. In 2006, 145-year-old Australian family business Michell Wool[15] opened its 14,000 square metre Suzhou factory for carbonising wool – a required process to clean the wool.

“The Chinese factory wasn’t to replace (our) Adelaide factory, but rather was to increase capacity through providing access to imported wool from countries such as France and South Africa, an opportunity not permitted in Australia due to quarantine regulations,” says Executive Director Peter Michell.

"In China, don't assume when it comes to occupational health and safety. The Chinese perception is often production first, not safety," explains Michell. "Contractors and factory workers are getting used to Western OH&S requirements but you still need to demonstrate how it is done, particularly from the top down."

Michell Wool does this by sending their Australian managers to China to train staff, and bringing Chinese senior management to Adelaide for training and development. This helps create a corporate culture that reinforces safety.

Cultural sensitivities can be problematic in the factory environment. "When you're the foreign boss, to save face, they often won't tell you if something is wrong or if they need help. For this reason it is vital to make the right decisions in front of them so they can see and follow you as an example," he says.

"There have been times where something hasn't been fixed that was meant to be on my last trip to China, and I have had to shut down the whole factory to reinforce the importance of repairing it despite costs. Safety and quality have to come first."

"Once trusted relationships are established in Asia, risk to the success of a project is significantly reduced."

But as years pass, Michell Wool is developing a capable workforce. "There was a lot of training in the beginning, but our managers are now becoming a lot more affluent and we are hiring more local Suzhou staff than when we first opened as the area develops," says Michell.

Having a good relationship with Australian government officials in the area, such as consulate staff, has also eased Michell's Chinese operation.

"We open our Suzhou doors whenever an Australian official visits, which helps demonstrate to Chinese government officials that we are well connected and respected at home. The *guanxi* we display from Australia is often as important as our local *guanxi*."

Essentially, differences in culture between two or more groups must be identified and consciously addressed. Once trusted relationships are established in Asia, risk to the success of a project is significantly reduced.

The Fred Hollows Foundation started working in Vietnam in 1993, one of the first projects in Professor Fred Hollows's mission was to eradicate avoidable blindness, often caused by cataracts.

The Foundation adapted its aims and programs to match Vietnam's rapidly evolving needs and priorities. CEO Brian Doolan stresses that relationships in Vietnam, as in many Asian nations, are "everything". "Sometimes it takes 12 months or 24 months or even three years to really establish proper trusting relationships," he says. "But that is the key to both business success and the key to personal enjoyment, because forming those relationships gives you such a rich experience."[16]

Brand risk

Brand risk can manifest in many guises – especially when operating in Asia. This section will focus on brand risk that emanates from rushing into lucrative Asian markets without being prepared, failing to accommodate the dangers posed by new technologies and social media, and failing to grasp vagaries of the intellectual property environment.

In Jonathan Copulsky's book *Brand Resilience*[17] he explains how brands are enormously powerful but also very fragile: they can bring great value including premium pricing, stronger customer advocacy, and greater permission to enter new markets, but these same advantages can also make a brand extremely vulnerable, especially since customers demand greater transparency and have the power, through social media in particular, to inflict lasting damage.

Rushing into Asia

A common problem for Australian companies wanting to engage with Asia is the desire to charge in without adequate basic preparation including deep research and rigorous testing of overseas partnerships.

Ignoring market and regulatory knowledge, on-the-ground engagement and logistical hurdles in the rush to get into Asia early can conspire to hurt the brand. Is it worth the risk?

> "Brands are enormously powerful but also very fragile: they can bring great value including premium pricing, stronger customer advocacy, and greater permission to enter new markets, but these same advantages can also make a brand extremely vulnerable."

Businesses, even those well-established in the domestic market, often learn the hard way and this is just what happened to the Australian brand Bundaberg Brewed Drinks, which grew markets in several Asian countries but then rushed into China under prepared.[18]

Entering the Chinese market in the early 2000s, it took on a local partner with limited research or knowledge. The relationship quickly proved very one-sided, with Bundaberg unhappy with its partner's lack of transparency on sales, distribution and customer details. Different values, business ethics and a lack of control also raised concerns. Bundaberg had no input into product promotion and sales, or ability to manage quality or contribute to strategic direction. Eventually, Bundaberg terminated the partnership.

Around the same time, Bundaberg became increasingly aware of similar worries with its other partnerships in Asia. Its initial ad hoc approach to partnerships involved simply selling cartons of Ginger Beer to distributors throughout Asia to get the product into the region. No additional support was provided to partners, such as help with branding or relationship-building. It was a basic purchase-order relationship with no product exclusivity. Challenges soon arose, with concerns about its partners' transparency as well as the impact of not having

targeted market-entry strategies to take advantage of future growth opportunities. Bundaberg decided it needed to slow down and be more strategic. "Go slow – it is harder to fix the mistake from rushing, rather than making the right decision in the first place," says Bundaberg CEO, John McLean.

Bundaberg is now focused on finding the right Chinese partner who meets its stringent selection criteria. It recognises that it might need several partners who will operate in the various regions across China, rather than simply one partnership. Bundaberg has also developed a cautious testing and sorting process. Potential partners are asked if they are willing to invest in marketing. They need to demonstrate strong relationships and connections with local food authorities and customs, and successful experience in importing and distributing beverages.

New technologies and social media

According to risk managers, brokers and insurance professionals, social media is the biggest threat to the reputation of firms operating in Asia.[19] Real-time networking on social media and the sheer speed of messaging is potentially catastrophic from a reputational risk point of view.

The top 20 countries for social media use (as measured by average hours that people spend on social media) include eight Asian countries.[20] Social media users in the Philippines ranked first with social media usage at 3.7 hours per day. Malaysia ranked sixth at three hours a day, Thailand and Indonesia eighth and ninth at 2.9 hours.

Zurich's regional head of international customer distribution and marketing Asia-Pacific Dylan Bryant says: "Previously, you could have an incident and it would take six months for everyone to find out, and by that point you've fixed it, and you're moving on, and you've got a positive outcome to develop. Now the same problem could be on social media within minutes."[21]

"According to risk managers, brokers and insurance professionals, social media is the biggest threat to the reputation of firms operating in Asia."

Australian companies manufacturing in Asia can also be exposed to reputational risk through supply chains. When the Rana Plaza clothing factory in Bangladesh collapsed in 2013 killing more than a 1000 people, brands connected to the factory were immediately targeted for bearing responsibility. They faced reputational damage if they did not commit to safety improvements.

Campaigners rallied western consumers to their cause mobilising them through social media and organising an online petition.[22] Consumers expressed their disgust at the use of sweatshops and cheap labour by rapidly moving away from the Australian brands involved.[23]

Intellectual property

Understanding intellectual property and preparing ahead of moving into an Asian country can also save headaches.

China is well known for a business environment that carries significant risks of counterfeiting and infringement of intellectual property (IP) rights. India may present issues around counterfeiting and scams. In the US both are on a Priority Watch List of countries having "serious intellectual property rights deficiencies".

Nevertheless, the Chinese and Indian Governments are concentrating on creating a more robust IP environment. In the meantime, Australian businesses should have in place formal legal protection of IP rights well before entering these markets, including a well-researched and executed strategy to protect their IP.

In China, another critical difference is that it has a first-to-file system requiring no evidence of prior use or ownership, leaving registration of popular foreign marks open to third parties, who register famous marks ahead of the legitimate owner. There have been cases of Australian companies whose brand had been registered in China by an unaffiliated Chinese party even before the firm considered entering the Chinese market. It can be difficult, time-consuming and expensive to recover these marks, so it is far better to register trademarks early. This should not in itself distract potential investors from the potential of the Chinese market. Risks, such as IP theft, can be managed, while the regulatory processes in China are improving.

> "There is inherent risk in doing business in Asia, and while no risk can be completely done away with, risk mitigation is entirely possible, as it is elsewhere."

Registering IP rights ahead of entering the Chinese market is essential because without doing so, an Australian business would be unlikely to be able to enforce them later. Treasury Wine Estates failed to register the Chinese name for Penfolds and became locked in a protracted legal battle with a trademark squatter in an effort to regain ownership of the iconic name.

An investigation by *The Australian Financial Review*[24] found that a rival wine company had registered three variations of Penfolds' Chinese name, Ben Fu. This potentially left Treasury open to a hefty fine for trademark infringement and could also allow the rival to sell wine using the Chinese name for Penfolds.

"Treasury has little choice but to buy back the name at a hefty price or relaunch the brand in China," said wine consultant Andy Tan from Mad Wines. "Actually the Chinese company has done nothing wrong. In China the first person to register the name has the right to use it."[25]

Electronics giant Apple, electric car maker Tesla and French winemaker Castel have all suffered similar problems in China, due to its so called "first to file" rule.[26]

Conclusion

There is inherent risk in doing business in Asia, and while no risk can be completely done away with, risk mitigation is entirely possible. A holistic and strategic approach is fundamental. Common sense, intuition and a focus on social responsibility should not be ignored. Additionally, a commitment to Asia rather than a quick jaunt to raid profits is more likely to set down a foundation on which there can be a long term return on investments.

Organisations operating in Asia who have their ear to the ground for political changes; who have employees with high cultural intelligence; and who are alert to brand risk in a foreign environment, are well ahead. Such businesses are more likely to be able to quickly adapt processes, products and services to capture new opportunities and respond to change across diverse markets.

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Acknowledgements

CEDA would like to acknowledge the following members and individuals who contributed to CEDA's general research fund between 1 March 2016 and 1 March 2017.

CEDA undertakes research with the objective of delivering independent, evidence-based policy to address critical economic issues, and to drive public debate and discussion. CEDA could not complete its research without the support of these contributors.

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ACIL Allen Consulting

AECOM

AEMO

AGL

Allens

APA Group

Ashurst

Australia Post

Australian Catholic University

Australian Rail Track Corporation

AustralianSuper

Bankwest

Broadspectrum

Bupa

Cardno

Chartered Accountants Australia and New Zealand

Clayton Utz

Commonwealth Bank of Australia

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Johnson & Johnson

L.E.K. Consulting

Macquarie Group

Macquarie University

Maddocks

Marsh

McCullough Robertson Lawyers

National Insurance Brokers Association of Australia

New Zealand Trade and Enterprise

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Clean Energy Council

CoINVEST

Colin Biggers & Paisley

CPA Australia

CQ University

CSL

Data #3

Data61

Deakin University

EPA Victoria

Epworth HealthCare

Ericsson

Extent Heritage

ExxonMobil

Fair Work Ombudsman

Fed Square

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GTA Consultants

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Origin Energy

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PGA Group

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Pinnacle Group

Pitcher Partners

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Squire Patton Boggs

Syrinx Environmental

Telethon Kids Institute

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Wellard Limited

Wesfarmers

Western Australian Treasury Corporation

Western Power

Woodside Energy

National
Level 13, 440 Collins Street
Melbourne VIC 3000
GPO Box 2117
Melbourne VIC 3001
Telephone 03 9662 3544
Email info@ceda.com.au

New South Wales and the ACT
Level 14
The John Hunter Building
9 Hunter Street
Sydney NSW 2000
GPO Box 2100
Sydney NSW 2001
Telephone 02 9299 7022
Email info@ceda.com.au

Queensland
Level 17, 300 Adelaide Street
Brisbane QLD 4000
GPO Box 2900
Brisbane QLD 4001
Telephone 07 3229 9955
Email info@ceda.com.au

South Australia and the Northern Territory
Level 5
2 Ebenezer Place
Adelaide SA 5000
Telephone 08 8211 7222
Email info@ceda.com.au

Victoria and Tasmania
Level 13
440 Collins Street
Melbourne VIC 3000
GPO Box 2117
Melbourne VIC 3001
Telephone 03 9662 3544
Email info@ceda.com.au

Western Australia
Level 5
105 St Georges Terrace
Perth WA 6000
PO Box 5631
St Georges Tce
Perth WA 6831
Telephone 08 9226 4799
Email info@ceda.com.au