Political risk

Is China becoming Russia?

by Arthur Kroeber

I. Back from the brink

Finally, the reality behind the July arrest of four Rio Tinto executives is emerging

On August 11 the Chinese government finally leveled formal charges against four executives of international mining company Rio Tinto arrested in Shanghai on July 5. The indictments were for theft of business secrets and bribery – substantially less serious than the originally threatened charges of stealing state secrets, which were tantamount to espionage. The case file was formally transferred from the Shanghai bureau of the Ministry of State Security (MSS), which handles national security and espionage cases, to the local Public Security Bureau (PSB), which handles normal criminal cases. The charges were filed at the last possible moment under Chinese law, which allows 37 days from detention to charge.

A few days before the indictments came down, we received an inquiry from a reader who wanted to know whether the Rio case proved that China was turning into Russia – that is, a country in which ordinary commercial negotiations are routinely subject to interference by state security forces, where foreign companies face constant risk of arbitrary abrogation of contracts and expropriation of assets, and business executives quite rationally fear for their liberty and occasionally their lives.

That was exactly the right question to ask. Fortunately, it appears that a lot of people within the Chinese government were asking the same question, and desperately trying to convince their superiors that the correct answer ought to be "No." Historically, China has done a good job of not letting its opaque authoritarian political system and vast legal grey areas obstruct business. Foreign direct investment averaging US$100 bn annually testifies to China's success in creating a stable and predictable business environment, despite well-advertised corruption problems. The Rio Tinto detentions, which elevated an acrimonious but ultimately quite ordinary commercial dispute into a matter of national security, threatened to destroy, at one stroke, an imperfect but largely deserved reputation for reliability built with much effort over three decades.

The lesser charges mean the Rio executives will receive relatively light sentences, averting a commercial catastrophe for China

The bland denouement averts that catastrophe. The coda will likely be a quick trial in which Stern Hu, Rio's China iron-ore boss and an Australian citizen, will be convicted and then immediately repatriated to Australia, probably on some spurious health grounds. His three less fortunate Chinese-national colleagues will likely receive relatively light sentences of a couple of years. On balance, the saga underscores the vast gulf between China's dynamic, flexible and commercially oriented political-economic system and Russia's thuggish mafia state. But it also serves as a timely reminder to enthusiasts inside and outside China who have been busy

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trumpeting the "Chinese century" that China has a long way to go before it can be taken as a true leader in the global economic order.

II. A few facts, and several hypotheses

Piecing together the facts of the case is troublesome

The known facts of the case are sparse. Stern Hu and his colleagues were detained on July 5 by officers of the Shanghai office of MSS. The following day the Australian foreign ministry announced that the detentions were on suspicion of espionage. This was formally confirmed on July 9, when the Shanghai MSS issued a terse statement that Hu and his colleagues had influenced Chinese iron and steel executives through "improper means" in order to spy and obtain state secrets, thereby causing "significant harm to the economic security and interests of the Chinese state." After that, the next set of facts – including, belatedly, the names of the three Chinese-national employees – came only with the formal indictments on August 11. (On July 8, Capital Iron & Steel executive Tan Yixin was detained in connection with the same affair. He was formally charged with taking bribes to reveal commercially sensitive information on August 5, a fact that did not become public until August 12, when the Rio charges were already known. Although the Chinese press has been full of rumors about how the Rio dragnet was going to be widened and many more local steel executives detained, this has so far not occurred, and we believe it will not.)

The detentions were almost universally interpreted – by Chinese as well as foreign reporters – as politically motivated. The most plausible hypothesis is that they were a power-play by the China Iron and Steel Association (CISA), which this year seized control of, and then memorably botched, the iron-ore contract negotiations between China's biggest state-owned steel mills and the iron ore oligopoly of Australia's Rio Tinto and BHP Billiton and Brazil's Vale. In prior years China's negotiators were led by Baosteel, the country's biggest steel maker – and many in the steel industry increasingly felt that Baosteel was caving in too easily to the miners' demands and not serving the domestic industry's interests. (Separately, the nation's smaller steel makers – many of whom are privately-owned and not members of CISA – tended to feel that the whole negotiation was a racket, since the big steel firms typically bought lots of ore at relatively low contract prices and then on-sold it at the higher spot price to smaller mills who were not included in the contract system.)

CISA botched its mandate to restore China's national pride after taking over iron ore price negotiations

CISA argued successfully that it ought to take over leadership of the negotiations, and seems to have received a mandate from senior leaders to restore China's national pride after years of supposed humiliation at the iron-ore bargaining table. It therefore took an extremely aggressive stance and refused to budge from a demand of a minimum cut of 40% off the 2008 contract price. Had CISA been quick to moderate its demands a bit and cut a deal in January or February, it might have done well. The world economy was in disarray, Chinese steel demand was still flat on its back, and a desperate Rio had agreed to a partial takeover by Chinese aluminium giant Chinalco. But March came in like a lion, with a huge upsurge in Chinese construction activity. As the spring wore on it became increasingly clear that Chinese steel demand would rise sharply. It also became evident that low-efficiency, high-cost domestic iron ore mines – which had supplied much of the ore demand in 2006-07 when spot prices were high – were closing down in droves. Traders now estimate that as much as 40% of China's domestic iron ore capacity has shut since last year.

With steel demand rising and domestic ore production falling, the Big Three didn't have to spend too much time at the abacus to see that ore imports and the spot price would soar, and that they therefore had no reason to settle on CISA's terms. Meanwhile they could line their pockets by selling their ore on the spot market to smaller Chinese mills at a discount of 20-30% to the 2008 contract price. CISA, which is not itself a commercial actor although it represents companies, and is mainly staffed by old-school retired executives and apparatchiks, was more concerned to maintain its prestige than to come to terms, and so found itself in an impossible negotiating stance.

CISA found itself in an impossible negotiating stance as steel demand rose but domestic ore production fell

III. Conspiracy of dunces

This much seems pretty clear; but now we enter realms of greater speculation. The most plausible hypothesis is that some of the big state-owned mills got tired of waiting for CISA to descend from its ideological high horse, and began back-channel negotiations with the miners, either to cut private side deals or to force CISA's hand. This pressure became more intense after late May, when Korean and Japanese steel makers settled for contracts at 33% off 2008 contract prices. Under this scenario, CISA, enraged by the efforts to undermine its authority, decided to send a message by orchestrating the arrest of the core of Rio Tinto's local contract negotiating team, and a solitary executive from a domestic steel firm. The idea would have been to throw the fear of god into the foreign miners, and to remind domestic steel firms of the cost of breaking ranks. The arrest of a single local steel executive arrest follows the usual pattern of "killing a chicken to scare the monkeys" and is unlikely to be followed by further arrests, despite local press rumors to the contrary.

Had CISA and its government allies settled for commercial bribery charges at the outset, they might possibly have achieved their aims; at any rate they would have done less damage to China's international reputation. But the advocates of the "strike hard" policy overplayed their hand and couched the matter in national security terms. This forcibly reminded the entire world that the interests of the Chinese state and big Chinese companies are difficult if not impossible to disentangle. In an instant, years of work persuading foreigners to believe the story that Chinese state-owned enterprises are autonomous actors pursuing purely commercial ends was flushed down the toilet.

CISA made a bad fist of a poor hand by couching the matter in national security terms

Is the leadership of CISA really stupid enough to engage in such tactics, and to fail to understand the implications? Absolutely. CISA's boss Shan Shanghua is the same man who, after Chinalco launched its February plan to take big stakes in some of Rio's prize mining assets, brayed to the

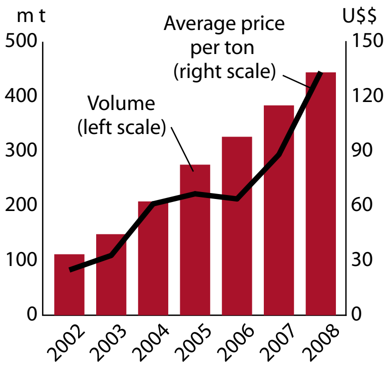
Chinese press that the deal was a great one because Chinalco would be able to force down the price of iron ore. His words will long be quoted by anyone anywhere who wants to oppose an outbound investment by a Chinese state-owned firm. We strongly suspect, however, that there were plenty of senior people in the Chinese government who woke up on July 6 and realized with horror, like our reader, that China was turning into Russia before their eyes. The next five weeks were almost certainly a period of frenzied lobbying and memo-writing which resulted ultimately in the climb-down of August 11.

IV. Mixed media

Yet while the Rio case will be cited for years by the paranoid folk who believe the Communist Party and Chinese SOEs are all part of a single carefully planned conspiracy to take over the global economy, we think the case shows exactly the opposite: there is no master plan, and China is a chaotic place where a large number of more or less equally powerful interest groups jostle for influence. And at the end of the day, commercial considerations and the importance of maintaining China's international reputation weigh very heavily in the balance. In these respects, China is not like Russia at all.

Ever upward

China iron ore imports



Source: CEIC, Dragonomics estimates

Consider, first, why China is paying more for iron ore than it did six years ago. Iron ore imports quadrupled, from 111m tons in 2002 to 444m tons in 2008, in line with a roughly comparable increase in steel production. The gigantic increase in Chinese demand had a disproportionate impact on seaborne ore prices, because unlike other major steel-producing nations, which make much of their steel in electric-arc furnaces using recycled scrap, China's steel industry consists almost exclusively of ore-fueled blast furnaces. Moreover, by 2008 fully 10% of China's steel production was being exported because capacity had been ramped up well beyond the voracious demand of the domestic market. Both because its domestic steel demand was rising so strongly, and because exports from Chinese blast furnaces displaced some recycled scrap steel, China provided a major upward boost for iron ore prices.

None of this was in line with the master plan for the steel industry championed by CISA and its friends at agencies such as the National Development and Reform Commission (NDRC). For years this plan has held that the steel industry should consolidate around a few (preferably state-owned) players. But cheap capital, local protectionism (which prevents industry mergers) and a roaring market have rendered that plan a joke: despite the thundering of bureaucrats, China's steel industry still has hundreds of players. Moreover, the past year has proved much kinder to the nimble private mills that produce mainly long (construction) steel, for which there is plenty of demand. The big state-owned players like Baosteel and Capital that invested heavily in glitzy new flat and stainless production facilities have seen their investments lie idle and their margins shrivel.

The story in steel is replicated throughout Chinese industry: cars, chemicals, electricity generation and dozens of other sectors are graveyards of government consolidation plans. Despite its ill-deserved reputation for economic omnipotence, the Chinese government has fared far worse than its Japanese and South Korean counterparts in organizing domestic markets around a concentrated handful of key players.

Conflicting interests among the different players in the steel industry played into the hands of the foreign miners

More broadly, our scenario suggests that the interests of various government ministries, of CISA and of the individual companies were distinct and in many cases conflicting. Many state companies hated Baosteel and authorized CISA to supplant it, only to find themselves hating CISA more and trying to work around it, probably by clandestine conniving with the foreign mining firms. The predominantly private smaller mills, which concerted state policy has failed to destroy, played a key disruptive role by providing the miners with a market that enabled them to ride out the endless negotiations. Government officials in different agencies almost certainly lined up on various sides of the issue depending on their bureaucratic commitments and ideological leanings.

This fractiousness was also evident in domestic media coverage. In the latter part of July, as Hu and his colleagues moldered away uncharged, Chinese media became increasingly acerbic in their denunciations of CISA's ham-handed negotiating tactics; the degree of license in local media coverage strongly suggested that no clear directive had been handed down from the senior leadership on how the story was to be covered. Towards the end of the drama, on August 9, a Reuters reporter spotted an essay that appeared on a website affiliated with the National Administration for the Protection of State Secrets that asserted the Rio case showed why Beijing needed to tighten its grip on economic state secrets. Ludicrously, it claimed that Chinese steel makers had been forced to overpay for ore by US$102 bn over six years, supposedly because of the Big Three's conspiratorial pricing policies and the collusion of their paid domestic collaborators. (In fact, import data show that price increases accounted for US$37 bn, or about two-thirds, of the increase in China's annual iron-ore import bill from US$3 bn in 2002 to US$59 bn in 2008; and all of that price increase is explicable by China's contribution to global marginal demand.)

The claim that China had overpaid US$102 bn for iron ore was probably the expression of an idiotic personal view

Given that this article appeared in a publication directly controlled by an important state agency, the foreign press quite understandably treated it as an indication of hard-line state policy. But after a day of international uproar, the article was hastily removed from the website. Since we now know that the Capital Iron & Steel executive had already been indicted on lesser commercial bribery charges before the article appeared, it is likely that the decision to prefer lesser charges against the Rio executives was already in place as well. Therefore the article could not have been an expression of national policy. It was either, as its author subsequently claimed, the expression of (idiotic) personal views, or an effort by a defeated national-security lobby to show the cost of failing to treat the Rio case with sufficient seriousness. Either way, the behavior of this and other Chinese media outlets is indicative of their diversity, not their unity in the service to a propaganda line from Beijing.

V. China isn't Russia. Whoopee

In short, getting back to the original question, the Rio case illustrates quite nicely why China is *not* Russia. Unlike Russia, which is in essence a strongman state where rules and laws are the barest fig leaves for the naked exercise of arbitrary power by a small group of people, China has a sprawling bureaucratic system characterized by balance-of-power politics between different political groupings, bureaucratic institutions and commercial interests. Power is distributed thinly enough among a great enough variety of actors that only rarely can any single actor impose its will unilaterally. Complex negotiated solutions are more common, and in these solutions considerations of commercial benefit and international reputation weigh heavily.

China is not as bad as Russia – but that is hardly a cause for celebration

This rates, at best, one cheer. If the best that China can say about itself is that it is not as bad as Russia, it has a way to go before it can become the global leader that some of its more enthusiastic publicists would claim it already is. The failure to meet even the most minimal developed-country standards of transparency in what can only with extreme generosity be called the "legal" proceedings against the Rio executives is a dismal reminder that Chinese law is more a matter of closed-door bureaucratic negotiation than due process. The national state secrets law, as amended in March, is extremely broad and vague, and permits a wide range of ordinary economic and commercial data to be treated as a matter of national security. This is particularly true of data in the hands of the giant state-owned enterprises that control broad swathes of China's domestic economy, account for the vast majority of its outward direct investment, and whose bosses are appointed not by boards of directors but by the secretive Organization Department of the Communist Party of China, which is subject to no law whatsoever outside its own internal rules. China isn't Russia – but it isn't yet a fully modern country, either.