

'Australia and China: An Iron Ore Partnership for the Future'

Ambassador Dr Geoff Raby Speech at 10th China International Steel & Raw Materials Conference 2010

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Introduction

Mr Shan Shanghua, Secretary-General, China Iron and Steel Association.

Distinguished guests, ladies and gentlemen.

It gives me great pleasure to attend today's conference, and I would like to express my gratitude to the China Iron and Steel Association for extending an invitation to me.

Today I would like to speak to you about the Australia-China relationship in the iron ore and steel sector.

This relationship remains central to the broader Australia-China economic relationship, and is a major driver of bilateral trade and investment.

I would like to share with you some of my thoughts about how we can develop this relationship in new directions in the future.

But first, I think it is important to place iron ore trade within the context of the overall bilateral economic relationship.

Australia-China bilateral economic relationship

Today the Australian and Chinese economies are more closely connected than ever before.

For several years, China has been Australia's largest two-way trading partner. In 2009-10, our total trade increased by 15 percent to 85 billion dollars. Last year, for the first time in Australia's history, China overtook Japan to also become Australia's single biggest export market.

It is hard to see a set of circumstances in the future under which China will ever be replaced as Australia's number one market. So last year marked a real watershed not only in Australia/China relations but also in Australian history.

Australia is also a key economic partner for China, ranking seventh among China's largest trading partners, and growing in importance.

Australia imports a significant amount of Chinese consumer goods, and we are becoming an increasingly important customer of Chinese mining, associated processing and infrastructure equipment.

Indeed, the expansion of Australia's mining industry and the corresponding increase in demand for mining equipment and infrastructure is helping to put China's heavy industry manufacturers on the world map. This is something I will talk about in more detail later.

With continuing strong growth in both the Chinese and Australian economies, two-way trade is likely to reach \$100 billion in the near future. This is double what it was when I first started as Ambassador in 2007, and no less than 50 times the amount of trade that existed between our two countries when I commenced my first posting to China in 1986.

Iron ore trading relationship

Iron ore is, of course, a critical component of bilateral trade between Australia and China, accounting for over half of Australia's merchandise exports to China.

This trading relationship goes back a long way.

Australia first began to sell iron ore to China as far back as 1973, only one year after the establishment of diplomatic relations between our two countries, and not long after the iron ore mining industry was established in the Pilbara region of Western Australia.

Commercial linkages between Australia's iron ore miners and the Chinese steel industry have grown from that time onwards.

The strength of these ties was reflected in the first Chinese investment ever to be made in Australia, the Channar Iron Ore Joint Venture in the Pilbara, which was entered into in 1987.

At the time, this was also China's first major investment overseas. It was also at a time very different from today. Then it was a buyer's market for iron ore, but China took a long-term, strategic view of the relationship when it made its investment.

That joint venture, worth A\$420 million at the time, was a trail-blazer for Chinese investment in Australia, and still stands as a symbol of Australia-China cooperation in the iron ore sector.

This early investment by China highlights a key aspect of the iron and steel relationship between Australia and China. It is a mutually beneficial one based on long-term interests.

The growth of trade in iron ore which has occurred in the following decades is nothing short of astounding, reflecting the huge transformation which has occurred in the Chinese economy over that period, and Australia's capacity to expand production and respond to the needs of our customers in China.

In 1990, for example, Australia exported less than 10 million tonnes of iron ore to China annually.

Now, Australia exports over 260 million tonnes of iron ore to China annually. This trade was worth over A\$21 billion in 2009.

The huge rise in Chinese demand over the past decade has caught Australian iron ore producers – and other producers around the world – by surprise.

The seaborne market for iron ore, for example, increased from about 500 million tonnes in 2000 to 940 million tonnes in 2009. China accounted for all of this increase.

Indeed, the impact of the global financial crisis has seen China become more important as a consumer of iron ore than ever before.

This is reflected in the fact that in 2009, while steel production fell throughout most of the world, China's production grew by 13 percent, and China now accounts for nearly half of world steel production. Ten years ago China's proportion of world steel production was around 15 percent.

The supplier response has contributed to a mining investment boom in the Australian economy.

This is not only being driven by the major miners. A number of new mining companies are emerging to help create alternative sources of supply. The most prominent of these is Fortescue Metals Group (of which Hunan Valin Iron and Steel is a major investor). And there are many other projects in the pipeline which together will add significantly to Australia's output capacity.

But, inevitably, the supply response has lagged behind the acceleration in Chinese demand, which has put short-term pressure on global prices.

This has generated a great deal of concern in China which is understandable given the strategic importance of iron ore for China's ongoing process of urbanisation and industrialisation.

But iron ore prices are fundamentally a result of global market forces, and are determined on a commercial basis between companies.

I would like to emphasise that, despite some of the media commentary you might hear on this issue, Australia remains the most competitive supplier of iron ore to China. Australia is even more competitive than many domestic suppliers.

Chinese customs statistics show that over the past ten years, iron ore imported from Australia has been on average about US\$12 per tonne less than iron ore from Brazil and India, on a landed basis.

Throughout this period, Australia has accounted for around 40 percent of China's iron ore imports, larger than any other country. But this share is in fact much less than it used to be. In the past, Australia has accounted for as much as 70 percent of China's iron ore imports.

This demonstrates two things. First, China has been able to expand its domestic production of iron ore. Higher iron ore prices have actually been very beneficial for this as China's iron ore resources are relatively costly to develop.

Second, China has significantly diversified its sources of iron ore imports. This includes not only by importing more from major iron ore exporting countries such as Brazil and India, but, increasingly, from new suppliers such as South Africa and Ukraine.

Recently, there have been changes to the pricing system which have resulted in a movement towards shorter term, market-based pricing.

In my view, these changes reflect the reality that the old benchmark system was unable to respond quickly enough to changes in market conditions. Ultimately, this was not in the best interest of either the seller or buyer. A new system was needed which could respond in a more flexible way to market developments.

Paradoxically perhaps, flexible pricing mechanisms lead to more stable outcomes, as frequent small adjustments in price allow demand and supply to respond more smoothly.

At the end of the day, there is no reason why iron ore should be considered any different from other commodities, which are priced on a purely market basis.

It is up to the companies, of course, to work through these changes together. In recent years, there have been tensions as both sides made the transition to the new arrangements. I believe this has now been done and companies have adapted to the new pricing system.

The role of Governments has been and will continue to be to create a strong bilateral framework within which companies can feel confident about the long-term economic relationship.

The Australian Government remains firmly committed to Australia's continuing to be a long-term, stable, competitive supplier of iron ore.

Outlook for China's iron ore and steel demand

China's demand for iron ore is likely to continue to rise for quite some time to come.

According to recent research published by the Australian National University, China's peak demand for steel could be reached when China's GDP per capita level is US\$15,500.

The researchers estimate that China's GDP per capita at 1990 constant prices to be about US\$5450 in 2008, this means China still has some way to go before attaining peak steel intensity.

They conclude that if China's GDP per capita continues on its post-1980 trajectory of 7 percent compound growth, it will reach this point during 2024. If growth follows the post-1990 rate of 7.8 percent, then the peak will be reached three years earlier.

Given China's huge population, this translates into around 1.1 billion tonnes of annual steel production, about 80 percent higher than today's level.

This result reflects the process of urbanisation and industrialisation which still has a long way to run in China.

Currently, just under half of China's total population of 1.3 billion live in urban areas. By 2030, another 200-300 million people are expected to migrate from the countryside to the cities, bringing the proportion of China's population living in urban areas to around 70 per cent.

This means that, over the next 20 years, China will require additional city housing and infrastructure for the equivalent of ten times Australia's current total population.

Australia's potential to meet China's iron ore needs in the future

Australia is well placed to supply the resources needed for the next phase of China's growth.

Expansion plans by the major miners and expected capacity from new suppliers will result in Australia having an output potential of well over 500 million tonnes of iron ore over the next two to three years. And there is potential for significantly increased growth in the years beyond that.

The Australian Government is committed to providing the best policy and regulatory support for the development of these iron ore resources.

This includes through investing in the infrastructure needed to service the mining industry and support new mining regions, such as the mid-west region of Western Australia.

It also includes welcoming foreign investment in our iron ore industry.

Australia welcomes and encourages foreign direct investment, including from China, because of the benefits that it provides our economy.

Australia has historically relied on significant international finance to open new investment opportunities and to develop our natural endowments.

Foreign investment not only provides additional capital for Australian growth, it creates new job opportunities and supports existing jobs, it encourages innovation and skills development, introduces new technologies and promotes healthy competition.

In recent years, there has been a substantial increase in Chinese investment in the Australia.

In 2009 alone, Chinese investment in Australia grew 151 percent to reach A\$9.2 billion. Much of this investment was undertaken by Chinese state-owned enterprises in the resources sector.

There are now dozens of Chinese-invested iron ore projects in Australia worth billions of dollars.

Chinese investment is particularly important in the development of Australia's magnetite iron ore resources. The Chinese steel sector has long experience in the use of magnetite ores, but until Chinese enterprises showed an interest in this type of material its development potential was not being considered in Australia.

Chinese investment and technology are the driving force behind the development of these resources.

This includes major projects such as the Karara iron ore project, being jointly developed by Gindalbie Metals and Ansteel. Another example is CITIC Pacific's Sino Iron project.

These projects have involved the introduction of process technologies little used in Australia, and a high level of collaboration between Australian and Chinese mining and metallurgical engineers.

Australia as a growing market for Chinese mining equipment

This brings me to the point I mentioned earlier, which is that Australia is a significant and growing market for Chinese mining equipment and technology.

All of Australia's major mining companies source mining, processing and infrastructure equipment from China. This market is worth billions of dollars in total, and is growing strongly.

Rio Tinto, for example, completed an order of 2,500 railcars from the Qiqihar Railway Company in 2009. This order was one of Rio Tinto's largest from any market.

The Karara project that I mentioned before is sourcing a range of items from China, including the magnetite concentrator and other processing equipment. Karara also has a large team in China working on the detailed design of the project.

And Fortescue Metals Group purchased iron ore stacking equipment from the Dalian Heavy Metals Company, and rail steel from Ansteel to service the heaviest haul railway line in the world.

And this procurement is not only related to iron ore projects.

Baosteel, for example, recently won a contract to supply a 400 kilometre pipeline to the CNOOC/BG Group Coal Seam Gas plant in Queensland.

And in 2009, CNOOC Engineering completed a Floating Production Storage and Offloading facility for BHP Billiton's Pyrenees offshore oil project. This highly sophisticated project was the first such order of its kind in China, providing CNOOC with important experience in this area.

The point is that the Australia-China economic relationship is bringing significant benefits to China's heavy industry and engineering sector, creating a shared value chain between our two economies.

Looking to the future

So what lies ahead for the Australia-China relationship in the iron ore and steel sector?

I believe there are a number of factors which will have a significant impact not only on the Australia-China relationship in this area, but the global iron ore and steel market more broadly.

The first is that China's appetite for iron ore will spur more Chinese investment in alternative sources of iron ore.

I have already detailed how this process has begun in Australia. Given Australia's abundant reserves of iron ore, I expect further activity of this kind in the years ahead.

But China is also looking beyond Australia to regions such as Latin America, Africa, and Central and South East Asia. It will also continue to expand its domestic production and in time scrap will become an increasingly important input.

The second factor relates to another important raw material input for steel – coking coal.

China's imports of coking coal jumped by 400 percent in 2009 to reach 34 million tonnes. Coal from Australia accounted for 65 percent of this total, albeit from a low base.

As China's steel production continues to grow in the years ahead, China is likely to look increasingly abroad for competitive, high-quality, sources of coking coal.

The third factor is the changing structure of China's steel sector.

As I previously mentioned, China is moving towards a steel production plateau. As China moves towards this plateau, it will increasingly seek to add value to its steel production and diversify its product and market base.

In addition, as steel production matures, Chinese steel mills are likely to put less emphasis on the bulk integrated steel mill output, and perhaps move towards alternative ironmaking and mini mill configurations for some of its production.

In this situation, Chinese steel mills may consider developing steel production facilities outside of China.

I myself have been giving some thought to the potential for China to develop steel production in Australia.

This issue has been looked at previously, but has not gained traction for a number of reasons.

However, conditions may now be changing in ways which make it a more favourable proposition.

This is particularly so given the development of magnetite iron ore resources in Australia, which lend themselves well to processing into high-grade products.

Now that Chinese companies have begun to invest in magnetite projects in Australia, there should be scope to consider the potential of going a further step into downstream processing.

While Australia does have higher labour costs than China, which would impact mainly on the capital cost, we can offer potential savings on the energy side.

A number of factors would need to fall into place to take advantage of the abundant natural gas sources of the conventional form in Western Australia and potential coal seam gas in the East of Australia, but it is possible that favourable supply and competitive conditions will eventuate in the Australian gas market in the medium to longer term.

Australia is also rich in other steel industry ferroalloying materials, such as molybdenum, nickel, manganese and titanium.

It is therefore conceivable for Chinese companies to consider establishing mini mill and finishing facilities in Australia, using alternative smelting or direct reduction based processing.

This would fit well with the overall restructuring of China's steel sector, and offer the potential for China to gain access to new steel export markets in Asia.

Alternative steel making technologies, and shipping steel, rather than iron ore, would also lead to lower carbon emissions, an important consideration given the likelihood of an increasingly carbon-constrained world in the future.

I have been fortunate to have visited most of China's major steel mills during my tenure as Ambassador. I have invariably been impressed by the scale and technological sophistication of these mills, and have no doubt that this expertise could be brought to bear by Chinese firms establishing steel production facilities in Australia.

Of course, this proposal raises a number of challenges, and there are many other issues which would need to be taken into account. But I have raised it today in order to provide food for thought about possible next steps in the development and integration of the Australian and Chinese iron ore and steel industries.

Conclusion

It is clear that Australia and China share a major interest in maintaining a stable, mutually-beneficial relationship in the iron ore and steel sector.

Australia is a competitive supplier of iron ore to China, and is committed to upholding this position over the long-term.

With our abundant iron ore resources, we are well placed to help China power its economy in the future.

The investments that are being made now to expand production capacity will significantly increase iron ore supply from Australia in coming years.

And with growing cooperation between Australian and Chinese companies in the development of iron ore resources in Australia, our economies have become more closely linked now than ever before.

This is a natural development, reflecting the economic complementary between Australia and China.

The challenge, in my view, is to think about how we can maximise this complementarity in new ways in the future, including through examining the potential for more of the production chain to take place in Australia.

I believe that with the joint efforts of both Australia and China, we can forge an even closer partnership in the iron ore and steel sector which will endure in the future.

I look forward to working together with you to achieve that goal.

Thank you.