Regional Free Trade Agreements and their Implications for Australian Financial Services

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Introduction

Australia has concluded bilateral free trade agreements with Japan, Korea and China during the course of 2014. Most attention has focused on the implications for trade in goods and services, where Australia already has well-established trading relationships with these three countries. Together, the three North East Asian economies account for over half of Australia's exports. The three regional FTAs open up significant opportunities for Australian exports of goods and services, as well as increased cross-border trade in saving and investment. The Australian economy also stands to benefit from lower prices for imports and easier access to foreign capital.

For Australian financial institutions, increased trade flows will increase the demand for financial services such as trade finance, insurance and foreign exchange trading and hedging. There is also increased scope for locally based institutions to intermediate cross-border capital flows and to provide funds management, insurance and other services directly to consumers and business in regional economies.

Japan, Korea and China have ageing populations, declining local investment returns and significant assets to invest abroad. For its part, Australia has a shortfall of domestic saving relative to domestic investment opportunities and a need to import foreign capital. There are thus potential gains from trade in saving and investment that have even stronger growth prospects than the already well-established trade in goods and services. Apart from these bilateral FTA's, Australia, Korea and Japan are members of the APEC Finance Minister's Asia Region Funds Passport initiative, which aims to provide a multilaterally agreed framework to facilitate the cross-border marketing of managed funds.

The Australia-China FTA has also seen the signing of satellite agreements that establish Sydney as one of only eight RMB trading hubs globally. China's gradual capital account liberalisation and the internationalisation of the RMB present significant opportunities for Australian financial institutions and fund managers to operate and invest in China. RMB internationalisation together with the establishment of local trading and clearing facilities should see a reduction in transaction costs in trading with China, increasing trade and investment flows.

Australia is also a participant in negotiations for the Regional Comprehensive Economic Partnership (RCEP) (includes China) and the Trans-Pacific Partnership Agreement (TPP) (currently excludes China). However, these negotiations have not been concluded and may not yield high quality agreements because of the need to accommodate a broader range of negotiating positions. Negotiating bilateral FTAs helps protect Australia's trading position where competing countries are also negotiating bilateral and regional agreements with our major trading partners.

The FTAs are seen as living agreements, with the expectation they will built upon over time, especially as China further opens up its capital account.

Australia's Existing Trade and Investment with China, Japan and Korea

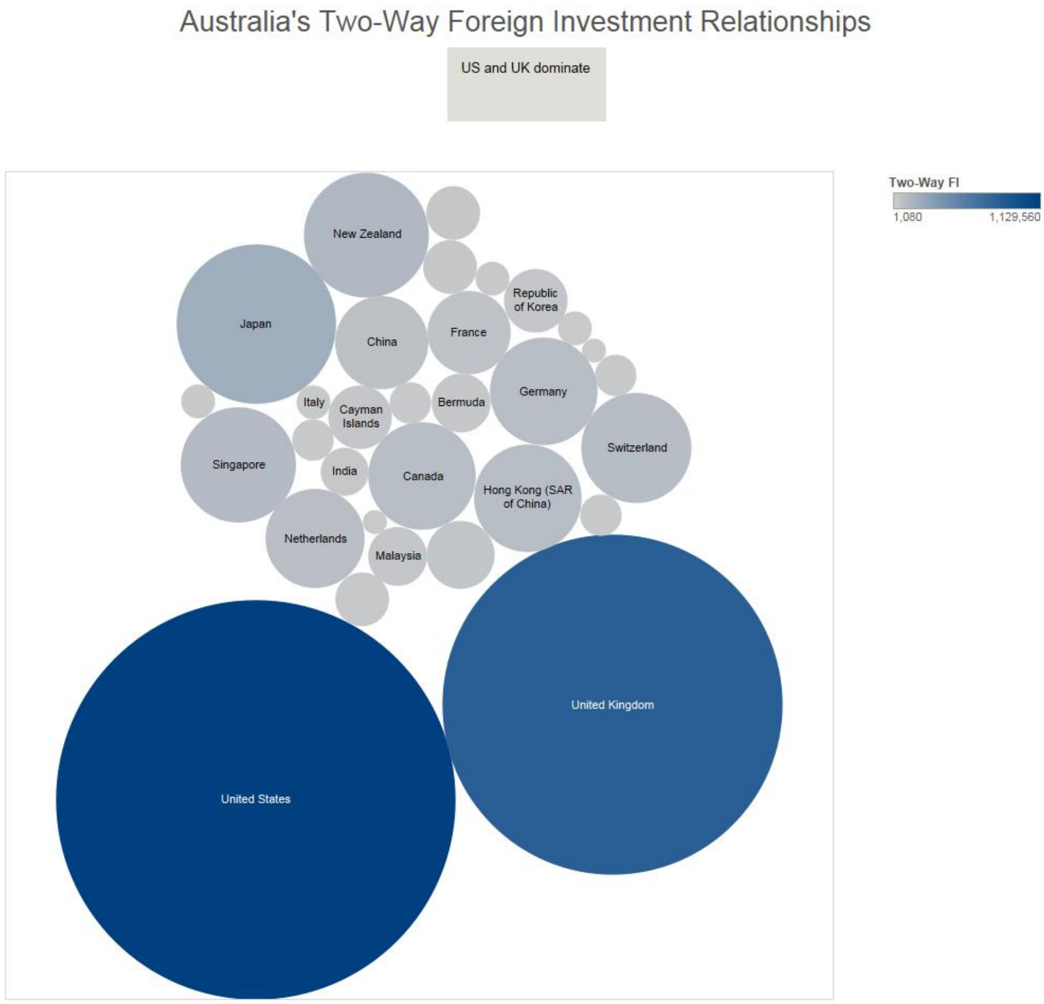
Australia's already has a very well developed trade relationship with China, Japan and Korea. The three north-east Asian economies account for more than half of Australia's exports and nearly 40% of Australia's two-way trade (imports and exports) (Table 1). However, trade is heavily skewed towards goods, particularly bulk commodities, rather than services. Services make up only 6% of Australia's total trade with the three economies, which leaves considerable potential for future growth.

Table 1: Australia's Trade in Goods & Services: China, Japan and Korea, 2013

	Goods ($A m)	Services ($A m)	Total ($A m)	% share total trade	Rank
Exports					
China	94,655	6,881	101,536	31.9	1
Japan	47,501	1,991	49,492	15.5	2
Republic of Korea	19,610	1,675	21,285	6.7	3
Total	**161,766**	**10,547**	**172,313**	**54.1**	
Imports					
China	47,250	2,079	49,329	15	1
Japan	18,914	2,307	21,221	6.5	3
Republic of Korea	10,168	646	10,813	3.3	9
Total	**76,332**	**5,032**	**81,363**	**24.8**	
Two-Way Trade					
China	141,905	8,960	150,865	23.3	1
Japan	66,415	4,298	70,713	10.9	2
Republic of Korea	29,778	2,321	32,099	5	4
Total	**238,098**	**15,579**	**253,677**	**39.2**	

Source: DFAT.

The investment cross-border investment relationship also remains under-developed, particularly in relation to Korea. China, Japan and Korea's share of the stock of Australia's inward and outward foreign investment is only 6.6% of the total (Table 2). This compares to 27.6% for the US and 20% for the UK. China, Japan and Korea account for just under 14% of FDI in Australia. The relative size of Australia's two-way foreign investment relationship with the rest of the world is shown in Figure 1, with the dominance of the US and the UK readily apparent.



Source: AFMA visualisation based on DFAT data.

In terms of Australia's foreign direct investment abroad, China, Japan and Korea barely register, accounting for only 1.5% of the total. Australian FDI in Japan and Korea has even contracted over the last decade. This is consistent with PricewaterhouseCooper's observation that Australia's 'level of investment in Asia is woeful.'[1] This poor performance is attributable to a number of factors, but two-way barriers to trade in goods, services and investment have played a part. The relaxation of these barriers through regional FTA's should see a broadening and deepening of the trade and investment relationship.

[1] PricewaterhouseCoopers, *Passing Us by: Why Australian Businesses Are Missing the Asia Opportunity. And What They Can Do about It.*, December 1, 2014, 4.

Table 2: Australia's Investment Relationship with China, Japan and Korea, 2013

	Stock ($A m)	% share	% change, 2003-13	Rank
Foreign Investment in Australia				
China	31,899	1.3	967.2	8
Japan	130,982	5.3	84.4	3
Republic of Korea	15,059	0.6	n/p	16
Total	**177,940**	**7.2**		
Australian Foreign Investment Abroad				
China	29,576	1.8	n/p	11
Japan	50,225	3.1	130.9	6
Republic of Korea	12,477	0.8	229.7	18
Total	**92,278**	**5.7**		
Two-Way Foreign Investment				
China	61,475	1.5	n/p	11
Japan	181,207	4.4	165.8	3
Republic of Korea	27,536	0.7	525.5	15
Total	**270,218**	**6.6**		
FDI in Australia				
China	20,832	3.3	967.2	6
Japan	63,257	10	244	3
Republic of Korea	1,972	0.3	n/p	18
Total	**86,061**	**13.6**		
Australian FDI Abroad				
China	6,350	1.3	n/p	12
Japan	477	0.1	-7.6	24
Republic of Korea	534	0.1	-58.2	25
Total	**7,361**	**1.5**		

Source: DFAT, *International Investment Australia*, 2013

The finance and insurance sectors stand to benefit most from any growth in the investment relationship as these sectors already feature very prominently in Australia's overall investment relationship with the rest of the world. Finance and insurance accounts for 46.9% of the stock of foreign investment in Australia, compared to only 6% for mining. In terms of Australian investment abroad, finance and insurance accounts for 65.3% compared to only 3% for mining. In terms of foreign direct investment, finance and insurance account for 11.2% of FDI in Australia and 28.4% of Australian FDI abroad, second only to mining.[2]

Australia's Financial Services Trade with China, Japan and Korea

Australia's insurance, pension and financial services trade with China, Japan and Korea is only a small share of Australia's total overseas trade in these services. Australia's exports to the three economies amounted to $225 million or 5.7% of Australia's total exports of these services in 2013. Imports of these services from the three economies were $71 million or 2.1% of the total (Table 3). However, it should be noted that these figures do not capture the supply of financial services through a local presence by Australian firms in these economies. The seemingly negligible exports of financial services to Korea does not reflect the substantial presence in the Korean market of Australian financial institutions. This presence is captured in the foreign investment statistics referenced above.

[2] Australian Government, *International Investment Australia 2013* (Canberra: Department of Foreign Affairs and Trade, October 2014), 64–67.

Table 3: Australia's Financial Services Trade with China, Japan and Korea, 2013

	Insurance & Pension Services ($A m)	% share	Financial Services ($A m)	% share	Total Insurance, Pensions, Financial Services ($A m)
Exports					
China	57	11.3	88	3.6	145
Japan	28	5.5	49	2	77
Republic of Korea	0	0	3	0.1	3
Total	**85**	**16.8**	**140**	**5.7**	**225**
Imports					
China	37	4.5	1	0.1	38
Japan	12	1.5	19	1.8	31
Republic of Korea	0	0	2	0.2	2
Total	**49**	**6**	**22**	**2.1**	**71**

Source: Adapted from DFAT, *Trade in Services Australia*, 2013

Korea-Australia Free Trade Agreement (KAFTA)

The Korea-Australia Free Trade Agreement (KAFTA) was signed in Seoul in April 2014. Implementing legislation was passed by the Australian Parliament on 1 October 2014 and amendments to customs, life insurance and foreign investment regulations have been finalised, paving the way for the agreement to enter into force on 12 December 2014.

Modelling by the Centre for International Economics finds that after 15 years of KAFTA's operation, Australian exports to Korea could be 25% higher than they otherwise would have been as tariffs and other barriers on Australian exports to Korea are removed.[3] This can be expected to benefit Australian financial institutions providing trade finance, insurance and foreign exchange trading and hedging.

Financial services exports to Korea as measured by the Australian Bureau of Statistics are currently small at $3 million in 2012-13, but this does not include services supplied by Australian financial companies through a commercial presence in Korea.[4] Australian

[3] Korea-Australia Free Trade Agreement, Regulation Impact Assessment, 4 February 2013, p. 21.
[4] Korea-Australia Free Trade Agreement, Regulation Impact Assessment, 4 February 2013, p. 16.

financial services companies are very active in the Korean market and there is considerable capacity for further growth.

KAFTA allows Australian financial services providers to supply specified financial services on a cross-border basis, enabling Australian suppliers to do business without the need to open a full commercial presence. Financial services defined by the agreement include asset management, investment advice for Korean investment funds and pension funds, custodial and trust services, reinsurance and brokerage insurance, and other insurance-related services.

Australia's total investment in Korea was worth $12.5 billion at the end of 2013, mainly in financial services and infrastructure. Korea has agreed to open its economy to Australian investors through the progressive raising of foreign equity caps and removing restrictions on investment in sectors previously closed to Australian investors, including the telecommunications sector, legal services, accounting and taxation.

The key reciprocal obligations of the Investment Chapter include non-discrimination, most favoured nation treatment, performance requirements and obligations on senior management and boards of directors. Under KAFTA, investments are protected and Australian investors, unless specifically exempted, are to be treated no less favourably that Korean investors in the establishment or acquisition, operation and sale of their investments in Korea. KAFTA also provides enhanced protections for Australian investors in Korea, with measures to ensure transparency, equitable treatment and security for investments. KAFTA protects Australian investors from discriminatory or arbitrary expropriation and nationalisation.

Korea's total investment in Australia was worth $15 billion in 2013. KAFTA will promote an increase in the flow of Korean investment into Australia by raising the monetary threshold at which investments from Korea in non-sensitive sectors are considered by the Foreign Investment Review Board from $248 million to $1,078 million, consistent with the thresholds provided in FTAs with the US and New Zealand. The Australian Government has retained the ability to screen investments in sensitive sectors, including media, telecommunications and defence related industries at lower thresholds. Cross-border acquisitions by sovereign entities are screened regardless of transaction size.

China-Australia Free Trade Agreement (ChAFTA)

The 10 year negotiations for a China-Australia Free Trade Agreement (ChAFTA) have been concluded with a Declaration of Intent signed on 17 November 2014, with the full legal text and implementing legislation to follow.

The deal is estimated to yield $18 billion in net gains to Australia over 10 years, although this estimate is now somewhat dated and likely underestimates the benefits of the agreement.[5] Trade in financial services can be expected to be a major beneficiary as China liberalises its capital account, internationalises its currency and allows greater flexibility in its exchange rate. China has recently relaxed controls on outward foreign direct investment, which is expected to see outbound FDI hit record levels in 2014.[6] This liberalisation should facilitate both inward and outward foreign direct investment and portfolio capital flows. Australian financial services companies are potentially well placed to intermediate these cross-border capital flows, as well as provide financial services in China.

Under the Agreement, Australian financial services providers will have access to China second only to that of providers in Hong Kong and Macau, both special regions of China. Access will be provided to banking, securities, futures and insurance sectors. Fund managers will be able to manage Chinese investments and Australian superannuation funds will be able to invest in the Chinese market. Australian insurers will be able to tap the lucrative compulsory third party insurance market in China.

Australian banks will get better access to the heavily protected Chinese market, where ownership is currently capped at 19.9%. China has agreed to reduce the waiting period for Australian banks to engage in RMB business from three years to one year.

Where a branch established in China by an Australian bank already has permission to engage in local currency banking business, other branches established by the same bank will be eligible for streamlined approvals to conduct RMB business.

China will remove the minimum RMB 100 million working capital requirement for branches of Australian banks operating as subsidiaries in China, facilitating faster growth and new business opportunities.

Australian bank subsidiaries will be the first foreign banks in China eligible to engage in credit asset securitisation business provided for under China's Financial Institution Credit Asset Securitisation Pilot Program.

Australian financial services firms will be able to establish joint venture companies with up to 49% Australian ownership. Australian securities firms in China will benefit from new commitments raising foreign equity limits to 49% (above China's WTO commitment of 33%) for participation in underwriting of domestic 'A' and 'B' shares as well as Hong Kong listed H shares, guaranteeing the ability to conduct a domestic securities funds management business.

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[5] Department of Foreign Affairs and Trade, *Australia-China Free Trade Agreement: Joint Feasibility Study*, March 2005.
[6] Thilo Hanemann, *The New Complexity of Chinese Outbound Investment* (Rhodium Group, December 1, 2014), http://rhg.com/notes/the-new-complexity-of-chinese-outbound-investment.

A separate Memorandum of Understanding between the Reserve Bank of Australia and People's Bank of China, also signed on 17 November, establishes official RMB clearing arrangements in Australia. This should improve the efficiency of cross-border transactions in RMB and gives greater confidence that RMB liquidity will be available in Australia, encouraging greater use of RMB in two-way trade rather than trading indirectly through the US dollar. Bank of China has been designated an official RMB clearing bank in Sydney.

Australian financial institutions will be able to invest offshore RMB in Chinese onshore financial instruments, including the Chinese onshore securities market, an area of potential growth for Australia's funds management industry.

It should be noted that direct trading in AUD-CNY commenced in mainland China in April 2013, with the PBoC announcing an official rate for AUD-CNY based on quotes from market-makers. Monthly turnover in AUD-CNY has ranged around USD 2.5 billion to USD 3.5 billion since then. Direct trading has led to more participation by Australian banks and should see a narrowing in spreads over time, reducing the costs of transacting in this currency pair.

Australia has also been granted access to the RMB Qualified Foreign Institutional Investor (RQFII) program, with an initial aggregate quota of RMB 50 billion. This should facilitate Australian fund managers investing in eligible Chinese assets.

A committee will be formed that will include the Australian Prudential Regulation Authority and the Australian Securities and Investments Commission along with their Chinese counterparts to discuss the possibility of mutual recognition of the licensing of financial services companies. This will potentially provide Australian wealth managers, advisers and securities companies with access to China without the necessity for local licence approval.

The Australian Securities and Investments Commission (ASIC) and the China Securities Regulatory Commission (CSRC) have agreed to strengthen cooperation.

Australian law firms will be able to form associations with local firms to offer Australian, Chinese and international legal services without restrictions on the location of clients. The ChAFTA will also facilitate professional secondments between law firms.

In relation to foreign direct investment, ChAFTA raises the Foreign Investment Review Board screening threshold for investments in non-sensitive sectors by private sector entities from China $248 million to $1,078 million, comparable with that provided for in Australia's other free trade agreements. The increased threshold will benefit investment in Australian commercial property by private Chinese firms, since most developments will fall below the threshold, enabling them to proceed without the costs and delays inherent in the FIRB process.

The Government has retained the ability to screen Chinese investments at lower thresholds for sensitive sectors including media, telecommunications and defence-related industries. FIRB will continue to screen investment proposals by private investors from China in agricultural land valued from $15 million and agribusiness from $53 million. These are lower thresholds than applied under previous government's foreign investment policy, reflecting pressure from the National Party. However, there has been no change in screening criteria, so there is likely to be little change in foreign investment outcomes as a result of the reduced thresholds.

FIRB will continue to screen investments by Chinese state-owned enterprises (SOEs), regardless of transaction size. Given the prominence of SOEs in China's economy, many cross-border acquisitions by Chinese firms will continue to be scrutinised by the FIRB regardless of size. By retaining the Treasurer's discretion over FDI by foreign SOE's, Australia's foreign direct investment regulatory regime creates uncertainty for potential foreign investors. This will limit the potential gains in cross-border investment that might have been seen if the increased $1,078m threshold had also been applied to SOEs under ChAFTA.

Japan-Australia Economic Partnership Agreement (JAEPA)

The Japan-Australia Economic Partnership Agreement (JAEPA) was announced in Tokyo on 7 April 2014 and signed in Canberra on 8 July 2014. The Government subsequently introduced legislation needed to implement the Agreement into Parliament on 29 October 2014. The Customs Amendment (Japan-Australia Economic Partnership Agreement Implementation) Bill 2014 was passed on 25 November 2014.

The agreement has been hailed as the most liberalising ever entered into by Japan, although concerns have been raised that Japan sees the agreement with Australia as a benchmark to limit concessions in the context of its TPP negotiations with the US.

The Centre for International Economics estimated the present value of the net change in Australian GDP from an FTA with Japan at $39 billion in 2005, but this is likely to underestimate the benefits of the agreement finally negotiated.[7]

JAEPA guarantees Australian services suppliers access to the Japanese market in financial, legal, education, and telecommunications services and provides Australian services exporters with the best treatment Japan has agreed with any other trading partner. Australian financial service providers have guaranteed access to Japan when providing investment advice and portfolio management services.

Consistent with other FTAs, the JAEPA raises the screening threshold at which private Japanese investment in non-sensitive sectors will considered by the Foreign Investment Review Board, from $248 million to $1,078 million. Australia will screen proposals for investment in agricultural land and agribusinesses at lower levels, consistent with the Abbott government's changes to foreign investment policy.

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[7] Centre for International Economics, *Australia–Japan Trade & Investment Liberalisation: Assessment of the Economic Impacts*, March 2005.

Conclusion

The three regional FTAs Australia concluded this year open up significant opportunities for Australian exports of goods and services. Services are currently under-represented in Australia's trade relationship with the three North East Asian economies at only 6% of the total. The cross-border trade in saving and investment is also under-developed, particularly in relation to Australian FDI abroad. There is thus significant growth potential in cross-border services trade and direct investment flows. The Australian economy also stands to benefit from reductions in its own trade barriers, lowering the price of imports and foreign capital.

Increased trade in goods and services can be expected to flow through to increased demand for trade finance, insurance and foreign exchange trading and hedging. Australian financial services firms are now potentially much better placed to intermediate increased cross-border capital flows, as well as to supply financial services directly to business and consumers in these economies.

The increase in the threshold for scrutiny of foreign direct investment by the Foreign Investment Review Board to $1,078 million for private investors in non-sensitive sectors, consistent with other FTA's with the US and New Zealand, should be particularly beneficial in enabling Australia to access foreign capital. A 2008 study by ITS Global estimated the annual cost to the Australian economy of FIRB scrutiny of foreign direct investment at $5.5 billion.[8]

Satellite agreements establishing Sydney as an RMB trading hub are particularly important in allowing Australian firms to capture gains from trade arising from the gradual liberalisation of China's capital account and the internationalisation of its currency. This should also lower transactions costs for bilateral trade between Australia and China.

The FTAs are conceived as living agreements and can be built upon to address new opportunities as they emerge. There is scope to link agreements through multilateral regional trade negotiations, including the TPP and RCEP, although the agreements also serve as a hedge against the potential failure of these broader trade liberalisation efforts.

[8] ITS Global, *Foreign Direct Investment in Australia - The Increasing Cost of Regulation* (Melbourne: ITS Global, 2008).