Rio Tinto-Chinalco deal collapses

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Anglo-Australian mining giant Rio Tinto has abandoned its controversial deal with the Aluminium Corporation of China (Chinalco), involving a $US19.5 billion investment by Chinalco in Rio, and announced instead an alliance with the Australia-based BHP Billiton. The Rio-BHP partnership will create a $US116 billion iron ore joint-venture in the Pilbara region of Western Australia to cut costs and establish a stronger bargaining position to combat downward pressure on global prices.

The June 5 announcement is a significant blow to Beijing's plans to establish a stable supply of minerals that is vital to its manufacturing, particularly its embattled steel industry. Chinese, Japanese and EU steel associations, as well as the World Steel Association, have all publicly opposed the Rio-BHP combine as monopolistic. The two miners have a combined annual output of around 270 million tonnes of iron ore. Together with the Brazilian-based Vale, the three control 70 percent of the world's iron ore trade. China, as the largest international steel producer, consumes more than half the global supply.

Rio and BHP reached an agreement with Japanese and South Korean steel companies in May for a cut of 33 percent in iron ore prices this year to $US61 a tonne. The Chinese Steel Association, however, has demanded a 40-45 percent cut and threatened to walk out of talks. The Chinese move is a break with the industry tradition that uses the first agreement struck in the annual round of price negotiations as the benchmark for the year.

Beijing has threatened retaliatory measures against BHP and Rio that would require the companies to obtain anti-monopoly regulatory approval before doing business in China. European and Japanese steel makers have also threatened to investigate whether the iron ore alliance violates anti-trust regulations. Behind the threats is a deepening crisis in the world's steel industry and manufacturing generally, which is producing a sharpening conflict between manufacturers and miners over prices.

The Chinalco deal with Rio was a product of the collapse of the commodities boom. In 2007, with demand for minerals still rising, BHP launched a $US135 billion hostile takeover bid for Rio with the aim of creating the world's most powerful mining behemoth. With prices up, Rio resisted the takeover and bought a major Canadian aluminium firm, Alcan. Chinalco, working on behalf of China's state-controlled steel companies, assisted in fending off the takeover by buying a 9 percent stake in Rio, making it the largest shareholder.

Following the plunge in commodity prices last year, Rio was struggling with nearly $US40 billion in debt, of which $8.9 billion is due in October 2009. Unwilling to be saddled with the debt, BHP dropped its takeover, leaving Rio desperate for capital amid a global credit crunch. As part of Beijing's "Go Global" investment campaign to take advantage of cheap equity prices, Chinalco reached a deal with Rio in February to put nearly $20 billion into the corporation in return for a higher stake and a series of joint ventures.

However, a number of factors operated against the plan. The Chinese government's domestic stimulus packages provoked short-term demand for steel, encouraging the sector to stockpile raw materials and speculators to hoard millions of tonnes of iron ore. The temporary rise in commodity prices provided Rio with a breathing space. In addition, Rio's management was under pressure from shareholders who were concerned that Chinalco would use its power on the board to influence iron ore prices.

In April, Rio's new chairman Jan du Plessis decided to abandon the Chinalco deal and secretly negotiated an arrangement with BHP to merge iron ore production in Western Australia to boost their joint bargaining power. As BHP produces less iron ore than Rio, it agreed to pay $US5.8 billion extra for its stake in the 50:50 joint venture, while Rio is to issue $US15.2 billion of new shares to pay off part of its debt. Meanwhile, Rio continued to talk up its original deal with Chinalco as a smokescreen.

Beijing's resentment at being outmanoeuvred boiled over publicly. The official Xinhua news agency described Rio Tinto as a "dishonourable woman" who was only after Chinalco's money. After Rio Tinto survived the most difficult financial stress, it stated, “she is breaking faith and kicking down the ladder”. Xinhua urged Chinese corporations, which are inexperienced global investors, not to trust anyone easily. Paraphrasing the maxim of international diplomacy, it declared: “There is only one rule in international dealings: that is, there is no eternal friendship, only eternal profit.”

For the Australian Labor government, the collapse of the Chinalco deal came as a political relief. Prime minister Kevin Rudd was confronting a growing protectionist clamour from the trade union bureaucracy, opposition politicians and business not to allow a state-owned Chinese company to gain control of strategic mining assets. Sections of the military establishment were also opposed to the Chinalco deal, warning that it would cut across Australia’s longstanding ANZUS defence alliance with the US.

Since World War II, Australia has been a key US ally in the Asia-Pacific. However, the revival of Japan as an economic rival to the US in the 1970s and 1980s, as well as more recently and China’s rapid economic rise have posed dilemmas for Canberra. Increasingly reliant on Asia economically, Canberra remained dependent strategically on the US military alliance. Amid allegations that the Rudd government was getting too close to the Beijing regime, the recent defence white paper described China as the biggest threat to US dominance, and by inference Australia, in the next 20 years.

China, however, is Australia’s largest trading partner, buying huge quantities of minerals as well as being a major source of tourists and overseas students in Australia. Australian trade minister Simon Crean tried to placate China, claiming the collapse of the Chinalco-Rio deal “wasn’t a government-induced decision”. In fact, the Rudd government has been stalling on granting approval to the Chinalco deal since February on the grounds that Canberra must consider “national interests”.

The *Financial Times* explained: “Canberra’s decision to extend its review period for the investment did provide time for public hostility to build and eventually, as commodities prices rallied, for Rio’s rising share prices to make the deal less attractive to its board. Opposition focused on the fact that Chinalco, as with virtually all large Chinese companies, answers to the leaders of the Communist Party. Barnaby Joyce, Senate leader of the minority National party, fronted a television advertising campaign stoking fears that Australia’s ‘source of wealth’ was being hijacked by a foreign government”.

The protectionist outcry against Beijing has more to do with strategic considerations. Japanese corporations, under the guidance of Japanese government, have made a number of major strategic investments in the Australian mining sector. For instance, the Melbourne-based BHP Mitsubishi Alliance is the world’s biggest exporter of coking coal for steel production, and two large Japanese steel companies, Nippon Steel and JFE Holdings, obtained a 57 percent price cut this year. None of these deals has been criticised as hijacking Australian wealth, because Japan is a major US ally.

Rio’s rejection of Chinalco has fuelled anti-Australian sentiment in the Chinese ruling elite. He Liangliang, a prominent commentator on Hong Kong’s pro-Beijing Phoenix TV, directly criticised Canberra, saying: “In fact, I believe in the end, the Australian government played a key role, though it will never admit that this is a political decision. If it did say so it would cause a greater storm, so it will only say this is a commercial decision.”

Facing a sharp economic downturn and a rising budget deficit, the Australian Foreign Investment Review Board has given the green light to smaller Chinese investments, such as China Minmetals’ $US1.39 billion takeover of embattled Oz Minerals. However, Canberra only agreed to that deal after blocking a mining project in South Australia’s Prominent Hill, on the grounds that it was too close to a sensitive military zone.

Amid the continuing global economic crisis, the collapse of the Chinalco deal is an indication of sharpening rivalry between the major powers for markets and raw materials. This month, the US and EU threatened to file a joint complaint against China at the World Trade Organisation, accusing Beijing of restricting export of 20 key industrial materials, mainly chemicals and metals such as zinc, tin and silicon, to give Chinese companies “unfair advantages”.