

**SPEECH TO ITOCHU AUSTRALIA LIMITED STAFF FORUM
FRIDAY 7TH JULY 2006**

Good morning ladies and gentlemen.

Opening Comment

It is a pleasure to address the Itochu Australia Limited Staff Forum this morning as you consider your company's strategy for entering the China markets. You note I say "China markets" because China is not a country but in reality a region akin to Greater Europe between Gibraltar in the Mediterranean Sea and the Russian Urals. Just as English, French, German and Italian are the main languages of Europe, so Mandarin, Cantonese, Shanghaiese and English are the main languages of China – certainly the business languages. However the different provincial, regional and even municipal dialects are very numerous and need to be at least culturally understood for marketing purposes.

Introductory Remarks

But first let me regress a little to tell you something about the ACCCI – the Australia China Chamber of Commerce and Industry of New South Wales – and thereby set the scene for my address this morning.

On Thursday 14th September 2006 the ACCCI will celebrate it's 30th Anniversary at a dinner in the Pavilion on the Park, opposite the New South Wales Art Gallery.

It will be a special highlight for me to host this Celebratory Dinner as President of Chamber, a position to which I was first elected on 17th November 1989. A date that happens to be my birthday. What a birthday present – the privilege to participate for almost 17 years in Australia's growing economic, diplomatic and all embracing general relationship with China.

Yet in June 1989 what has evolved with accelerating momentum over the last 17 years would have been thought totally impossible. As tanks rolled down Tiananmen Square in Beijing, China's varying relationships with Western countries, so assiduously cultivated by Deng Xiao Ping and other leaders of the Chinese Communist Party for over a decade, were in tatters and soon to get worse with almost universal trade sanctions against the PRC which in the case of the USA lasted until 1994. The mass protests of the Chinese during the years 1987/89 were in essence a campaign against Party corruption and for the creation of alternative centers of power, as well as responses to the economic impact of China's opening to the world.

These issues are yet to be resolved as witness the recent speech by President Hu Jintao to the 85th Anniversary Celebration of the Chinese Communist Party, founded in Shanghai on 1st July 1921, where he attacked “rampant corruption” in the Party. In a nationally broadcast 90-minute television speech, and in his capacity as Secretary General of the Chinese Communist Party, President Hu stated that anti-corruption campaigns and building a clean government were “an important strategic mission” for the Chinese Communist Party. He acknowledged that corruption was still rampant with many cadres abusing power for personal gain, and called upon the 70 million CPC members to avoid “greedy desire that harms the people” and “money worship”.

Put very bluntly, corruption, whether economic, political or social, is far worse today in China than it was in the late 1980s. The range of Party, Government, Military, Business whether State or Private, leaders and middle level officials shot or imprisoned for commercial “crimes”, political “deviations”, and/or community “excesses” is extremely unsettling and a challenge in the medium to long term for the success of the current Chinese experiment of integrating their society into the global community. Will the ‘mandate of heaven’ continue for this Communist Dynasty?

So I conclude my introductory remarks with the most salient principle for ‘Doing Business in China’. At the end of the day, the bottom line, the Communist Party of China is the most powerful institution in the country and at least centrally, under President Hu Jintao as compared to President Jiang Zemin, becoming even more powerful and indeed authoritarian. The difference today in 2006 is that after almost 30 years of the Open Door Policy the Communist Party of China is no longer a united monolith but rather a fractured organisation of competing ‘power factions’ representing Peasants (Rural), Workers (Urban) and Entrepreneurs (Business). This is compounded regionally by the diversity of the Chinese society as mentioned in my opening comment.

Content and Structure of PowerPoint Presentation

Personally as I get older I become more and more a believer in the KISS Principle re ‘Keep It Simple Stupid’. The problem is that nothing is simple in China. Perhaps that is why Itochu Australia had some difficulty in enlisting the support of Itochu Japan, Itochu International, Itochu Hong Kong or Itochu (China) Holdings Co.

Indeed I have noted the 16 or 17 Offices Itochu maintains in China, with a good representation in the Northeast including the provincial capital cities of Shenyang, Changchun and Harbin, and also an impressive spread along China’s East Coast from Beijing and Tianjin in the North via Qingdao to Shanghai, Nanjing and Ningbo in Central China, to Xiamen, Guangzhou, Shenzhen and Hong Kong in the South. However I am surprised to learn that there appears to be only one non-coastal Office re Sichuan in the Western China.

Now there maybe a number of reasons why one of your Head China Honchos is not addressing you this morning.

- a) They are too busy making money in China.
- b) Australia is considered too small potatoes in the Itochu scheme of things.
- c) No one has an overview of what is happening in China and particularly how it relates to Australia.
- d) The language problem of speaking English on reasonably complex business matters.
- e) And even dare I say it, internal Itochu competition – like the World Cup no other country really wants the Australians participating at full strength on a level playing field.

Whatever the reasons my advice to you is to never give up in using internal company resources – your existing Itochu network in China is a substantial asset. However you should also always have external Australia-centered advice – a second opinion to the highest levels of management in Itochu Australia. It is in this sense that I view my role this morning – the emphasis will be on insights rather than mind crunching numbers and details that you can find out for yourselves on the internet or elsewhere.

A. TRADING RELATIONSHIPS WITH CHINA

Working for a major international trading corporation such as Itochu should make it easier to view China's recent history in the global context. We presently witness one of the most challenging events in history namely over twenty percent of humanity re-entering the world community officially since January 1979. I am sure Itochu International does not suffer from the bi-lateral tunnel vision of most Australian companies. Trading relationships with China should be viewed from all perspectives – Japanese, American and European. Long gone are the years of Hong Kong's de facto control of entry to the 'China market', whilst Australia's trade relationship, excluding the commodities industries, is relatively miniscule.

From China's perspective there are many sources of information. However for my purposes the China Daily at www.chinadaily.com.au/home is sufficient. It gives a good overview of the PRC Government's global views and priorities. There is also a reasonable Business section. From this daily reading you will be kept abreast of China's trading and other relationships with the world. And there will be some interesting comments on Australia.

On Australia's relationship with China I do not find our media very helpful – basically they are both too sensational and very erratic. Although some interesting opinions are expressed from time to time in the Age, Sydney Morning Herald and Australian. For example I draw your attention to recent articles by the Australian's China Correspondent Rowan Callick.

By way of background reading I would suggest the quite recent two reports of the Australian Senate's 'Inquiry into Australia's Relationship with China' respectively entitled:

- 1) "Opportunities and Challenges: Australia's relationship with China" tabled on 10th November 2005 and
- 2) "China's emergence: implications for Australia" tabled on 30th March 2006.

It is worthwhile reading many of the 83 submissions that deal with the bilateral trading relationship in the broader context. Not only from the Department of Foreign Affairs and Trade (DFAT) and the Australian Trade Commission (Austrade) but also from at least eight federal departments namely Agriculture, Fisheries & Forestry; Transport & Regional Services; Industry, Tourism & Resources; Communications, Information Technology & Arts; Education, Science & Training; Environment & Heritage; Immigration, Multicultural and Ethnic Affairs and finally Family & Community Services.

In addition there are substantial submissions from the Embassy of the People's Republic of China in Australia, the Australia China Council, Human Rights Council of Australia, Australia China Business Council, Australian Industry Group, Australian Council of Trade Unions, National Farmers Federation, Australian Local Government Association, and CSIRO Business Development & Commercialisation not to mention the Victorian, Queensland, Western Australian and Northern Territory State Governments.

The only notable absentees are the New South Wales State Government and the Australia China Chamber of Commerce and Industry of New South Wales. However in the case of ACCCI we did prepare a submission and agree to give testimony before the Senate Inquiry Committee Members in Canberra on the condition that Chamber representatives would not comment on corruption in China. For some reason the Committee sittings on the day of our scheduled appearance were cancelled. Nevertheless I gave an extensive interview to Focus Reports, a Geneva based organisation retained by the Chinese Ministry of Commerce, which was published in the International Business Daily and appears on the ACCCI Website at www.accci.com.au

My point is that Australia's trading relationship with China is in fact a very broad economic, social and cultural business relationship. This is why you have organisations as diverse as the Australian Strategic Policy Institute, National Library of Australia, Australian Academy of Sciences, Australian Research Council, Queensland Nurses' Union, Australian Film Commission, Wollongong City Council and the Western Australian Symphony Orchestra making submissions. With respect to Symphony Orchestras, ACCCI worked to assist the Adelaide Symphony visit China during the late 1990s. 100 musicians performing in four Chinese cities – from memory Beijing, Jinan, Qingdao and Shanghai -

cost over \$1 million Australian dollars. The Western Australia Symphony has been looking for that sought of corporate sponsorship.

With respect to a broad overview of Australia's current trading relationships – at least statistically – and specifically concerning China including the Hong Kong SAR and Chinese Taipei, the DFAT website at www.dfat.gov.au is omniscient. A good introduction would also be Trade 2006: the annual statement made by Mark Vaile, Deputy Prime Minister and Minister for Trade.

A number of points regarding the mainland are made and worth emphasis:

- China is now the world's fastest-growing major economy
- China is the world's sixth largest economy – it may even be higher at 4th
- China is the world's third largest trading nation after the US and Germany
- China is currently Australia's second largest merchandise trading partner – number two as both an import and export source. Two-way merchandise trade quadrupled over the past decade to the value of \$37.4 billion in 2005
- China is Australia's third largest agricultural export market – up 300% in the last decade
- China is Australia's second largest market for minerals and fuels – having grown by over 700% over the last decade. Previously predominantly iron ore but soon liquefied natural gas as well.
- China is Australia's fourth largest export market for manufactures – up over 160% since 1999
- China is Australia's fifth largest service market – with the largest single contingent of foreign students (over 81,000) enrolled at Australian educational institutions and about 284,000 tourists estimated to grow to over one million by 2014

Otherwise the DFAT Website will give you for the mainland:

- China Fact Sheet
- Bilateral Trade and Investment Fact Sheet
- Country Brief
- Australian State/Territory Trade with China (which is a new and potentially valuable tool of analysis)

And for Taiwan or Chinese Taipei:

- Taiwan Brief
- Fact Sheet
- Austrade – Taiwan page (which is most helpful)

And finally the Hong Kong SAR;

- Hong Kong Brief

- Fact Sheet

All in All:

- 1) Total merchandise trade between Australia and 'Greater' China approaches **\$50 billion** Australian dollars (re \$37 + \$9 + \$4) and
- 2) Total services trade about **\$6.35 billion** Australian dollars (re \$3 + \$0.6 + \$2.75)

How does this compare with Japan?

- Merchandise trade - **\$45.5 billion**
- Services trade - **\$5.1 billion**

Or the European Union?

- * Merchandise trade - **\$51.1 billion**
- * Services trade - **\$16.9 billion**

B. RISKS OF BUSINESS – AND THEIR ALLEVIATION

On the ACCCI Website you will find a speech delivered by Mr David Eldon to an Asia Society/HKABA Luncheon in February 2004. Mr Eldon was then Chairman of the Hong Kong and Shanghai Banking Corporation. Entitled "Sweet and Sour: The Realities of Doing Business in China" he identifies some "common misconceptions".

- China is not a single market, rather a collection of markets As I have said elsewhere the "socialist market" is in one respect an extremely fierce competition between provinces, regions, municipalities, special economic zones, export processing areas, and various high-technological development zones. Change is constant and rapid.
- Chinese consumers are not "there for the taking". In fact they are very sophisticated, experienced and knowledgeable and enjoy the attention of the best global companies from Japan, the US and EU and other countries.
- China's business organisations whether SOE or Private are not ripe for acquisition or merger. Rationalisations there will be, some even quite dramatic, but foreign takeovers I believe will be in percentage terms be very small.
- Despite China's membership of the WTO foreign companies will not be treated equally to Chinese which one way or another will be favoured. The legal system is certainly improving, however as Mr Eldon understates "the enforcement of judgments still has room for improvement".
- The Chinese Government will not collapse under the weight of it's "multiple challenges", many of which are listed, because firstly China has already made the transition from a command to a market economy, and secondly because China has the expertise, financial and otherwise of Hong Kong – and I would add Chinese-Taiwanese companies.
- China's foreign companies are making money. Mr Eldon quotes a pole of 250 foreign companies of which 75% stated they were profitable and 10%

“very profitable”. Simply put when entering the China markets you should not “leave your business commonsense at home”.

In summary he states the obvious – there are no shortcuts to building a business in China, companies have to work hard, be realistic and not idealistic, reasonable patient and not irrationally exuberant, with the right perspective namely a long-term focus and not a short-term agenda.

Should you visit the DFAT website in the China Country section you will find a section on the proposed Free Trade Agreement negotiations. Apart from the Update of meetings there are short summaries of business and company concerns respectively from the Australian Agriculture, Mining and Energy, Manufacturing, and Services sectors, plus comment on Investment interests and ‘Behind the border’ issues. In effect these Australian difficulties or impediments to doing business in China can also be interpreted as some of the business risks and are worth considering in terms of the Itochu strategies and plans across your large number of industries and activities.

Finally I would like to make some brief observations from my 20 odd visits to China and particularly the intensive six visits during the two years 2002 and 2003. I made formal speeches on Chamber activities across our Policy Committees, Annual Forums and Special projects from:

- Changchun in Jilin, and Shenyang and Dalian in Liaoning, through Jinan and Qingdao in Shangdong, obviously Beijing and Tianjin, as well as Shijiazhuang in Hebei, and Hohhot in Inner Mongolia – all in **the North**
- Shanghai, Wuxi and Nanjing in Jiangsu in **East Central** China. Unfortunately I had to cancel meetings in Hangzhou and Ningbo in Zhejiang.
- Fuzhou in Fujian, Guangzhou in Guangdong, Guilin in Guangxi and Sanya in Hainan in **the South**
- Nanchang in Jiangxi, Hefei in Anhui, Changsha in Hunan, Wuhan in Hubei, Chongqing, and Chengdu in Sichuan in the **Central West** of China
- Xi’an in Shaanxi, Lanzhou in Gansu and Urumqi in Xinxiang in the **North West**

It was very apparent to me that people under 40 years were heavily western influenced, which usually means American but with some significant pockets of European “worship”. With the effects of the one child policy starting to impact, the old traditions were disappearing fast accelerated by modern communications and widespread domestic travel, reinforced by still relatively limited international educational opportunities.

This trend was exasperated by the introduction of early and mandatory retirement ages for Chinese government officials that included SOE.

Depending on the organisation and situation this could be from 55 years but was usually 60 and sometimes as late as 65 years. A whole generation of senior

managers disappeared in the late 1990s. During the early/mid 1990s I quite regularly met leaders of Chinese delegations in their early 70s, today it is unusual to meet anyone over 60 years and even 55. A 60 year old in 2000 remembered first hand the Cultural Revolution of 1965/75. A 35 year old today can barely remember Tiananmen Square.

When people rely on the media for their history there are risks. Deng Xiaping's exultation "to be rich is glorious" has been well and truly taken to heart by all sectors of the Chinese society. Always remember that the 'Safety Nets' of social policy that we take for granted in western countries – less so in John Howard's Australia – are non-existent in China which makes their society akin to that of the US 'Cowboy Culture' between the end of it's Civil War in 1865 and entry to the First World War in 1917- the era of the 'Robber Barons'. China also has a "Go West" policy!!

Finally I want to comment on several concepts from a business perspective.

- Cost – regulations at all levels effectively make things dearer than expected, especially in the East
- Time – negotiations have to be face to face by leaders, with the necessary hospitality in the evenings which often becomes 'a gauntlet'
- Knowledge – even graduates from elite Australian universities know very little about Australians, and I suspect the same for other countries
- Attitude – westerners are rich or should be, display and ostentation are mandatory, money is the criteria for everything
- Change – personality reinvention, future loyalties, existing contracts etc are variable according to the circumstances and often without notice
- Disputes – the 'rule of law' will be a long time coming, better to befriend a high level Party member who holds a multitude of positions and has some national economic pride.

C. OPPORTUNITIES FOR ITOCHU AUSTRALIA – AND IT'S CORE INDUSTRIES

All of these insights, observations and comments would be well known to Itochu Corporation in Japan. However they may be a little surprising for the senior executive managers of Itochu Australia. Similarly my approach to China trade opportunities for Itochu Australia may be somewhat different to others. In my view context is all important.

In reading the Itochu websites across the world, and particularly the 2005 Annual Report – 'Maximizing Our Competence', I was interested in a number of matters:

- **Net Income from Major Overseas Trading Subsidiaries –**

Itochu Australia Net Income increased from 0.1 billions of yen in 2004 to 0.7 billions in 2005. However it remained the smallest subsidiary in terms of Net Income. China remained steady from 0.8 to 0.9 and Hong Kong rose from 1.2 to 1.5 billions of yen. Interestingly Europe was up from 0.3 to 0.5 and Itochu International a whopping 1.4 to 8.6 billions of yen. Perhaps there was some creative accounting in the last figure or a significant restructuring of the international 'empire' in the lead-up to the establishment in April 2005 of the Overseas Operations, Administration and Development Department in Japan. These trends may have continued for 2006, I do not know?

- **Organizational Structure and Focus**

Itochu Corporation now has seven Division Companies namely Textile; Machinery; Aerospace, Electronics & Multimedia; Energy, Metals & Minerals; Chemicals; Forest Products & General Merchandise; Food; Finance, Reality, Insurance & Logistic Services; operating out of Overseas Offices and Domestic Offices. Itochu Corporation Oceania is responsible for Itochu Australia and Itochu New Zealand.

My understanding is that in recent years the Itochu Corporate Strategy has been to shift "from a Defensive to Offensive Footing".

- **Growth Strategy - Frontier 2006** - identifies:

- 1) Firstly, focusing on segments in which Itochu can demonstrate unique competence namely the Consumer-Related and Natural Resource sectors AS WELL AS in North America and Asia including China – for example the strategic alliance with China's top food business group, Ting Hsin International Group, in order to speed up the opening of about 2000 FamilyMart stores throughout the country by February 2009.
- 2) Secondly, exhibiting both lateral and vertical comprehensive strengths and specifically "to look beyond the individual Division Companies to develop business across the entire Group" – in essence a cross company approach to opportunities presented by business alliances such as with Orient Corporation (Orico) and their 620,000 affiliated retail outlets.
- 3) Thirdly, anticipating social changes to create new business which will become "the main source of Itochu's future profits" and specifically selecting three core fields namely consumer business, healthcare & living services, and innovative technologies. To this end a Strategic Business Development Department was established in April 2005

With respect to China what currently exists is a situation where “Itochu has taken the industry lead in penetrating the Chinese market with respect to the Consumer-Related and Natural Resource Development sectors, and has developed a network of contacts, distribution routes, and collaborative relationships with major local Chinese companies”.

Obviously Itochu Australia should exploit the situation, but in a manner consistent with the culture of business, growth strategies and structure of operation for Itochu Corporation and Itochu Australia.

These are issues about which I have little knowledge outside my previous experience with American and European corporations. Nevertheless reporting procedures, to whom, when and how, are important for all organisations. For example the new Strategic Business Development Department falls under the Chief Operating Officer, Division Companies Operation; whereas the Overseas Operations, Administration & Development Department is under the Chief Officer for International Operation, apparently three levels below. As already mentioned both Departments were established in April 2005. How does this work?

Where exactly does Itochu Corporation Oceania sit in ‘pecking order’? How does the recently appointed Itochu Australia Ltd MD and CEO, Mr Roy Saito, progress Australian business initiatives with respect to China? My question is simply rhetorical: what is his power and authority in relation to the China and Hong Kong Divisions to deal directly between Australia and China, whether by way of trade or joint venture (including investments in either country) and so forth?

This is very important for me since the Chamber’s Mission is to generate economic relations between Australia and China, not Japan and China or the USA, EC or ‘Mars’ with China. That is why our Company Membership Fees are prohibitive for non-Australian companies and why Chinese companies not based in Australia can only become Associate Company Members. ACCCI also has a culture of behaviour, business ethical procedures, strategies and operational structures etc.

This is an interesting situation requiring a review of both:

- Itochu Australia – what are its “unique competencies”, where are the “lateral comprehensive strengths to develop business across the entire group” and are there new business opportunities identifiable in the consumer business, health and living services and innovative technologies.
- ACCCI - its assets in China, resources and capabilities in Australia, as well as strategic approach to bilateral trade relations.

Itochu's core activities in Australia are essentially Natural Resources re Coal, Iron Ore, Alumina, Wool, Oil, Forestry, Food and Silica Sand. It seems to me that the Other Business, re CICA, Chemical Products and IT & Communication, is at this stage relatively minor. Please correct me if I am wrong?

With respect to Natural Resources you no doubt have it covered – there would be further opportunities at least at the margins of:

- Exporting to China
- Importing from China
- Joint venture investments in both countries
- Sole venture investments in either country

However in the area of a 'lateral' move into new business, the inspiration may well come from other Country Divisions as well as assistance from the Head Office Corporate Industry Divisions.

My suggestion is that Itochu Australia and New Zealand consider jointly establishing an Oceania China Strategic Business Development Department with the objectives of ascertaining future:

- **Chinese economic development needs;**
- **Australasian economic capabilities to participate;**
- **Outcomes and implementation of the current FTA Negotiations;**
- **SME mentoring and facilitation through China 'clustering';**
- **Federal/State Government business alliances with the private sector**
- **Support for the Strategy and Programmes of the ACCCI**

From Chamber's perspective a very important objective would be to guard and protect Australian and New Zealand interests. China is big enough to take care of itself.

For about a decade Chamber has been advocating and refining an approach to China based on the premise that ultimately the Chinese Economy will be so essential to global growth that it's political and social stability will be the major concern of most countries.

This approach relies on an analysis of Key Cities in China and Key regions in Australia and New Zealand with a structure built on:

Policy Committees

- Trade Policy - collective responses by governments regionally
- Commercial Policy – escalating alliances between corporations/firms
- Public Affairs – growth of NGO and their influence on all societal issues
- Cultural Affairs – societal change from greater 'people to people' contacts

Annual Forums

- Rural Industries – jobs and livelihood currently for about 800,000 people
- Urban Services – support for a rapidly growing city based lifestyle
- Infrastructure – linking cities/regions to both the world and themselves
- Commercial Culture - the rise of an affluence private-property middle class

Special Projects

- AIIP – across the board investment in Australia
- AEBTCP - on-shore education and training for the masses in China
- AITCP - technology collaborations in both countries
- ATSSP – specific purpose tourism for selected groups from each country

As you will realize all of these ACCCI activities have significant implications for business and will increasingly bring greater and greater commercial opportunities for those companies aware of societal trends and pressures.

Concluding Remarks

The Itochu Corporation has a very significant advantage, namely a multi-lateral perspective to China based on its overseas Country Divisions and domestic Industry Divisions management structure.

Business opportunities can be identified globally in the various regional groupings whether European Union, North America or Oceania, or domestically according to the development plans of the Chinese Central Government such as the Bohai Sea Strategy that seeks to bring together economically the provinces of Shandong, Hebei and Liaoning with Tianjin and Beijing; or the Pan Pearl River Delta Region Transport Plan to integrate the southern provinces of China with South East Asia.

Australia's participation in this global reorientation of international trade patterns and trends is necessarily limited owing to the size of our market, except for the commodities/resources industries in which Itochu Australia is well placed to play a leading role.

The new business opportunities will be niche markets, predominantly technology related, and dependent on alliances of small companies with major international corporations.

Final Comment

In ending my address to you this morning may I suggest that Australia and Japan, given our broad and profound economic relationship since the 1950s, have a unique opportunity for joint venturing in China. But to be successful we must continue to place maximum emphasis on the 'people to people' societal contact between our two countries. Our relationship with each other should not

become an appendage to other relationships whether with China, the USA or EU. The rise of China and its challenge to the United States could be an incentive for an even deeper relationship between ourselves.