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# Australia-China and Stern Hu: A Dint in Relations or “Business as Usual”?

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## ABSTRACT

*China's economic growth over the last decade has been spectacular and Australia has been a beneficiary of this growth in terms of China's demand for resources and the strength of Chinese exports. Pundits even suggest that Australia avoided the global recession as a result of this strong trade relationship. Trade relations between Australia and China resulted in China becoming Australia's key trading partner. The arrest and charging in 2009/10 of four Rio Tinto executives (including Stern Hu the head of Rio's operation in China) based in China raised fears of posing a strain on this vital economic relationship. Moreover China's inability to takeover Rio Tinto and the significance and consequences of this incident are at the core of this paper. How do these events reflect the uncertainties of doing business in China or do these events demonstrate China's sovereign right to enforce anti-corruption legislation? While China has embraced the international business community, to what extent has the arrest and imprisonment of Stern Hu changed the Australian-China trade relations including doing business in this thriving and buoyant market?*

*Keywords:* Australian-China Trade Relations, Corruption, Economic Growth, International Business, Rio Tinto

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## INTRODUCTION

The aim of this paper is to offer a critical analysis of the strategic significance of these events. Specifically the two areas examined are impact on firms doing business in China and second the Australia-China relationship. China is a relatively new player in capitalist trade and its adherence to the market principle is unique and contradictory. The Chinese Communist Party is the ultimate power and while many commercial operations will take place independently, when they come to a sticky end, often the Party's firm hand will come to the fore. While acts of

corruption and industrial espionage are at the fore of these events, do they simply cloud over greater events occurring in the relationship and the exchange between the Chinese and Australian firms? Can a deal gone wrong like this one make the corruption accusation simply a front for deeper and more far reaching matters of principle in the background?

In July 2009, four Rio Tinto executive were arrested by the Chinese government for allegations of bribery and stealing state secrets. Stern Hu, the head of the Anglo-Australian miner's Shanghai office, and three of his Chinese colleagues, Wang Yong, Ge Minqiang and Liu Caikui were sentenced on March 29, 2010 to ten, fourteen, eight, and seven years

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prison respectively. The four were convicted of accepting bribes totaling about \$US14 million and stealing trade secrets throughout the period of iron ore negotiations between the China Iron and Steel Association (CISA) and Rio Tinto (Mcdonell, 2010).

The four were convicted of accepting bribes in return for helping private Chinese mills secure access to relatively low-cost and stable term iron ore from Rio Tinto. They were also convicted of stealing commercial secrets that helped Rio in iron ore negotiations with Chinese mills. The commercial secrets included information about a steel mill's production cut, a list of licensed iron ore importers and proceeds of meetings held by the China Iron and Steel Association (Hornby, 2010). On the 8th of April 8 Stern Hu, decided not to appeal his conviction for accepting bribes and stealing commercial secrets. Immediately after the verdict, Rio Tinto dismissed the four executives citing "dishonourable behaviour" (Hornby, 2010). This seemingly insensitive behavior by Rio Tinto might also be explained by the possible repercussions which Rio Tinto would face due to Australia's signature of the OECD anti-bribery legislation. Stern Hu's three Chinese colleagues sentenced at the same time on the same charges, decided to appeal the ruling. A number of China's most active iron ore importers were named as the bribers in the court's verdict, including iron ore trader Sinochem International, privately owned Rongcheng Steel in Tianjin, also known as Rockcheck Steel, and private steel mills Tangshan Guofeng and Hebei Jinye (Hornby, 2010).

From the Australian government perspective and specifically through the voice of the Foreign Affairs Minister at the time, Stephen Smith, on any measure, the penalty given to Stern Hu was considered a "this a tough sentence," though in the same breath there was "substantial" evidence that Hu was guilty of bribery (Sainsbury, 2010). Stern Hu and his colleagues all admitted taking bribes from small and medium private steel mills in exchange for providing them with access to regular supplies of iron ore at better prices than they could get from state-run mills. But they argued during the

case about the size of the amounts they have been accused of receiving.

The arrest of the Rio Tinto executives occurred after Rio rejected an offer of \$US20 billion from the state owned Chinalco and the collapsed iron ore negotiations (Business Today, 2010). The charges were supported by the confiscation of inside information and data which Stern Hu and others had in their possession on Chinese Steel Mills which was interpreted as a threat to China's national security. News of the arrest and later the trial of Stern Hu ultimately involving Australian companies and executives produced media frenzy in Australia. A brisk and firm Australian government response took little time to arrive. To raise the tension level, Australia complained about the trial being closed to the public. Australia's then Prime Minister Kevin Rudd challenged the Chinese government stating 'The world will be watching how this particular court case is conducted' (Dodd, 2010). It fed into the resurfacing of 'jingoistic' fears of China of once upon a time which had been expressed some months earlier by the opposition finance spokesman Barnaby Joyce soon after Chinalco made an offer to takeover Rio Tinto. Joyce stated:

*"The Australian Government would never be allowed to buy a mine in China. So why would we allow the Chinese government to buy and control a key strategic asset in our country? Stop the Rudd government from selling Australia."* (O'Brien, 2009).

The case has raised fears of posing a strain on the vital economic relationship between Australia and China. China's Foreign Affairs ministry was taken aback by the campaign emerging in Australia in Stern's defense and warned Australia against 'politicising' the trial over the court's decision to hear the charges of infringement of commercial secrets in a closed courtroom session. With the trial ended the spotlight is back on China's desire to secure access to its resources for its surging economy. This incident also draws attention to the extent that China cannot allow market forces to totally

determine its commercial relationships. Specifically Australia, the beneficiary of China's thirst for resources, and the home of the mineral giants Rio Tinto and BHP have tried to shift blame and focus of this incident away from themselves and on to the Chinese political and legal system. One need ask if we are replaying Cold War tensions, or is it a scenario of the uncertainties of doing business in China. Corruption is at the centre of the arrests deeply involving Australian firms, resources and ultimately the Australian relationship. What will be the impact of these events on this special relationship?

### Doing Business in China

On the whole China has been an enormous beneficiary of economic globalisation within the global economic system. Since the mid 1990s, Beijing has promoted China on the global stage and welcoming to foreign businesses. Beijing's message has been that its political values will not dilute the existence of a rule-of-law environment within which foreign businesses operate. For the most part, especially in the low-technology manufacturing and export industries, this remained true.

However doing business with China has not been an easy task which has been discovered by many international MNCs (multinational corporations) after heavy financial losses. One of the major challenges has been the cultural differences and hence the impact of such differences on its business practices. The first and the very fundamental difference is its economic system. China has 'a market economy with socialist characteristics'. This is a unique system with a centrally planned fiscal system administrated by the central government with aspects of a 'free market economy'. This unique structure is difficult to comprehend by firms and organisations especially those which come from well established market economic structures abroad (Chung, 2008).

However, cultural differences are often hard to comprehend as they are less tangible compared to technical and marketing issues. Corporations without culturally-suited strategic

planning usually end up paying huge costs for failures that result (Chung, 2008). To draw a medical analogy; all seems well on the outside, because culture lies under the skin, but it remains at the heart of everything and can bring the whole system down because of a massive heart attack (Chung, 2010).

The lack of understanding and transparency of the Hu's case increased fear among executives and observers that the risk of doing business in a country with a huge market but at the same time close ties between the ruling Communist Party and the State authorities. Some foreign companies at the forefront of advocating closer political and economic engagement with China in order to get a slice of the pie could soon change their minds. It certainly has raised the questions among foreign companies whether the arrests might indicate that regulatory, protectionist and the political environment in China is changing and possibly becoming difficult for foreign companies to see the advantage of continuing to invest in China.

At the same time, the Chinese government re-iterated that Hu's arrest was not politically motivated or related. It was their insistence that illegal activities, including corruption would not be permitted while conducting business in China. Moreover the reaction of Chinese business community as a whole on this matter and the media reaction towards Hu is important. Hu is in the category of that of many Chinese who went overseas and did well and as such found themselves assisting foreign companies. In some cases the media used the description of 'traitor' to describe him and illustrate a dissatisfaction of Chinese working for foreign firms. Is there any element of the 'red eye' syndrome (envy and jealousy) one would ask (Chung, 2008).

In short, doing business in China is a challenge for all international organisations. The complication of its political and economical system together with the different way of doing business in China makes all transactions multi-dimensional therefore careful assessments of situation and capacity to handle these business transactions with the Chinese way are crucial for doing business in China.

## Rio's Relationship with Chinese

Cultural differences influence the interpretations of the goals of the negotiating parties which may differ dramatically from their actual goals. For instance, when the Chinese make gestures to Westerners that they cannot agree to certain things because, the outcome may result in the Chinese losing face. If the Westerners do not understand the significance of this cultural nuance, the negotiation process may be jeopardised or experience difficulties. A real example of this situation was the negotiation of the iron ore prices in 2006 between Rio Tinto and BHP and Shanghai Bao Steels and other Chinese steel mills. Historically, the international iron and steel market has been self regulated in a way that once the leading suppliers and purchasers negotiated and agreed to an international market price, it is to flow on to the rest of the market. Up till most recently, Japanese and European steel mills have been the larger and/or largest steel purchasers. Earlier in 2006 the world's biggest iron ore producer, CVRD a Brazilian company won a price increase of 19 percent with European steel mills for 2006-2007 contract prices. This flowed on to contracts signed with both CVRD and Rio Tinto with Japanese steel mills in May 2006 of a 19 percent price increase (Wyatt 2006).

China was furious after the announcement of the news. Having become the biggest steel producer, consumer and iron ore consumer in the world, China found itself in a politically face losing position that they have failed to perform the role of the largest by leading the price adjustment. Worse still was China's loss of face to the Japanese. By May 18, 2006, China was in a difficult situation. BHP, Rio and CVRD went on to negotiate with the rest of the world steel mills to secure 57 percent of the world market with a 19 percent price increase in order to force China into a corner to agree to the price increase. By May 29, 2006 China, however, was hinting the possibility of opting for the spot market price in order to save face (Wyatt, 2006). The end result of the negotiation was indeed to force China to the negotiation

table however, straight after the signing in June, Chinese media launched a major campaign denouncing Westerners and Australian companies as the 'evil capitalists' who were taking advantage of the Chinese and its rapid economic development. This has caused major set backs for the relationships between Chinese and Australian iron ore producers.

One other cultural character of the Chinese is their long-term memory especially on insults and hurt feelings. China is gearing up for the forthcoming negotiation of their new contracts. There is a Chinese saying 'A gentleman's revenge is not late even if he has to wait for 10 years.' The Australian negotiators might have won their negotiations in 2006, and have forgotten about the glory in 2009. Chinese will not (Chung, 2009). Will the Australians be getting the quantity and the price they need to keep the economy at a manageable rate is yet to be answered.

If we had the magic to reverse the globe like we do in movies, the companies should have sought for advice on the cultural understanding of 'the face issue'. The entire negotiation could have been handled very differently to avoid the negative publicity and still achieve the desired results. One Chinese official remarked that such actions violated international rules and conventions, he said: 'This will not be helpful in building long-term and stable cooperative relations between suppliers and buyers' (Chen, 2006). The China Iron and Steel Association also suggested that 'negotiating rules' were broken during this year's price discussions and a 'stable long-term co-operative relationship' was clearly not built well enough by the Australian producers (Freed, 2006).

What was most humiliating to the Chinese was the loss of face rather than the price increase. Australian negotiators often puzzled by the fact that Chinese negotiators might bargain so hard on the price in a negotiation and then sign a contract with a different company with a higher price. Bargaining of price sometimes may be the smoke screen for the Chinese attempting to tell the Westerners of other problems, often it is an issue of lose face (Chung, 2008).

Though China joined the WTO in 2001 and has only over the last three decades encouraged inward investment into its own country, it has seen fit to not allow this openness to be an invitation to act with unnecessary aggressiveness by western powers and economies. In many respects the Hu incident is merely an opportunity for China to remind Rio who is in charge of this relationship in their own country (Chung, 2009).

However, the unique market situation has created opportunities for Hu and his colleagues to engage in illegal activities. Rio entered the Chinese iron ore market in 2001. From 2003, the market changed from a seller's market to a buyer's market. Rio enjoyed a large portion of the Chinese iron and ore market. Previously, large steel mills such as Bao Steel and Capital Steel would negotiate and purchase iron ore from Rio and then on going to sell to smaller steel mills at double the price. To some small steel mills, they might only gain access to iron ore through third-hand transaction (Huaxia.com, 2010).

### **Australia's Relationship with China**

Australian relations with China were established in late 1972 after decades of Cold War standoff. The last decade, primarily through the resources boom and the strength of Chinese exports, trade relations with China have been strong. They were further strengthened with the election of a mandarin speaking Prime Minister, Kevin Rudd in 2007.

Thought the incident over the Stern Hu arrest has brought out bad habits of the past in Australia and appears to have continued the stalemate of the Free Trade Negotiations between China and Australia, (Callick, 2010) the two countries have nonetheless reached even greater trade achievements in the past 12 months.

In late 2009 (four months after the arrests), it was announced that China had overtaken Japan to become Australia's biggest trade partner. Trade between the two countries in 2008-09 reached a staggering \$A76.3 billion (DFAT,

2009). Australia shipped \$A22 billion in iron ore alone to China in 2008-09, or approximately 42 per cent of Chinese iron ore imports (DFAT, 2009). In 2009 China purchased \$53 billion of iron ore last year – the equivalent of both Japan and Korea's total purchase. This relationship is delicate and dependable (Chung 2009).

The then Australian Minister of Trade, Simon Crean, warily highlighted that the trial and confessions of the Rio Tinto executives would have no impact on Australian trade relations with China nor on Australia's resource trade with China or sensitive iron ore sales negotiations (Callick, 2010). The Minister stated: 'If there were links you would have expected the trade had fallen, yet last year China became our largest trading partner. The two matters are separate (Taylor & Regan, 2010).

This line has also been maintained consistently by the Chinese government. A constant message that has been sent by the Chinese government to the foreign companies was that they are welcome to do business in China. They are also welcome to enjoy profits however it must be based on legitimate conduct. The judge presiding over Hu's case, Justice Liu Xin, said the four men had seriously damaged the competitive interests of Chinese steel companies. He said their actions forced Chinese steel companies into an unfavorable position in price negotiations and this led to the collapse in iron ore price negotiations in 2009 (McDonnell, 2010).

The irony in all of this is that Kevin Rudd at the time was the first Prime Minister to speak Chinese which he has flaunted during the lead up to his election and after in government. He even referred to himself as a Chinese business consultant before being elected (Chung, 2009). At the same time, the Australia-China political relationship is at its historical low since the 1970s.

### **Implications for Business**

The fact that parts of the trial was behind the closed doors and the rejection of Australian government representatives' participation relating to the commercial secrets allegations makes

foreign businesses feeling uneasy. The argument of transparency and uncertainty for those doing business in China has increased. Australian opposition Foreign Affairs spokeswoman Julie Bishop expressed that this is an issue of great concern to many companies from Australia and also from around the world (McDonell, 2010) however no government official has ever been able to identify exactly what the concern is.

Exactly what is the implication for business is a matter of debate between the Chinese government and Western businesses. Perhaps companies should first carefully examine their business conduct in China first before defending their positions like the case in Hu's situation. Rio's executive Sam Walsh defended Hu and his colleagues soon after their arrest stating 'our employees have acted properly and ethically' (Rio Tinto, 2009). Evidence that millions of Yuan in bribes had been stuffed into bags and boxes for the accused was heard in court in March 2010 during the trial (Tang, 2010). Hu also took money from small private steel companies, which before the global financial crisis were locked out of buying iron ore from Rio because the mining giant prioritised large state-run steel companies (McDonell, 2010).

According to the Chinese media (Xinhua, 2010) Mr Du, the former head of Shangdong-based Rizhao Iron and Steel group, claimed he paid the Rio employees millions of dollars for preferential treatment in the area of iron ore. Soon after the guilty verdict declared for Stern Hu and his three colleagues, Rio terminated their contracts (Rio Tinto, 2010). In Australia, under the Criminal Code Amendment (Bribery of Foreign Public Officials) Act 1999, bribery is subject to maximum penalties of imprisonment for ten years or a fine of up to \$66,000 or both. Corporations can also be liable where their employees, agents or officers commit offences while acting within the scope of their employment. The penalty for a corporation which commits an offence can be as high as \$330,000 (Chung, 2009). To date, no one has asked the question whether Rio had knowledge of their ex-employees misconduct and whether

Rio should be accountable for their actions in this incident as well as its China based employees.

The Chinese media has argued that in China Hu Stern's case was non-political. The Chinese legal community highly praised the Chinese government on being able to keep its political and commercial activities separate and believed that the legal process was fair and proper. According to one source, China's legal practitioners were very pleased how well the Chinese government conducted the case (Tang, 2010).

## CONCLUSION

China's engagement with the world community has been one of the key geo-strategic developments of the last decade. Moreover China's 'two system' nature, a development of the mid 1970s has been the driver of the insertion of China as a business player. Many nations and the western capitalist system however remain uncertain how to relate to this different reality. This has without doubt created uncertainties in terms of conducting business and relating to China. Another consequence has been the insistence from China that they will not allow their open country for business with lesser respect than that accorded to western nations. The events surrounding the Hu Stern case has allowed China the opportunity to send a message of enforcing anti-corruption laws meant not be taken lightly by western nations. A new protocol for relating to China has been sought and with all likelihood this incident which will first and foremost affect Australian trade with China. It will in our view not be the last.

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