Dragoman Digest.

26.03.2021

More unpredictability for investors under Brazilian President Bolsonaro

Bolsonaro ally with no oil or gas experience at the helm of state-controlled Petrobras

Brazilian President Jair **Bolsonaro**'s pick to replace the CEO of state-controlled Petróleo Brasileiro (Petrobras) may presage further political meddling in the economy. Bolsonaro replaced Roberto Castello Branco with retired army general and political ally Joaquim Silva e Luna. Silva e Luna has no experience in the oil and gas sector.

Bolsonaro likely replaced Branco to protect his political base after months of intense protests over price increases for petrol. The protests escalated after Petrobras sought to align domestic fuel prices with international levels to help sell off refineries. Silva e Luna has signalled that he will suspend any increases to fuel prices. Petrobras' campaign to divest a string of assets is also likely to be halted. Petrobras' board could plausibly limit Silva e Luna's power as CEO. However, the government has appointed six of the 11 board members.

Bolsonaro's interference with Petrobras is potentially a red flag for investors. Petrobras planned to divest between US$25 and US$35 billion in assets from 2021 to 2025. Bolsonaro pledged to privatise Petrobras before the end of his term in 2022. This is now in doubt. As his popularity has dwindled and the risk of his impeachment rises, Bolsonaro has increasingly surrounded himself with allies – sometimes at the expense of key campaign promises like his privatisation drive. State-controlled Eletrobras may be the next company to be targeted, after Bolsonaro threatened more announcements targeting sectors that "may not be working."

Desire to counterbalance the China-Russia partnership a likely driver of investment in peripheral Russian region

President Putin may find political convenience in playing great and emerging powers against each other

Russia's underdeveloped Far East region may be the latest sphere of **India**'s competition with **China**. India announced plans last week to invest in the region in a range of sectors from pharmaceuticals to liquified natural gas (LNG). This is the latest initiative in Prime Minister **Modi**'s "Act East" policy, launched in 2019. **Japan** was also involved in discussions with India and Russia in late January concerning planned investments in the LNG, coal and transportation sectors.

The Japanese and Indian initiatives are likely attempts to act as a counterweight to Russia's growing strategic partnership with China. China has been the Far East's primary foreign investor, providing over 70 percent of all direct foreign investment in the region and 28 percent of its foreign trade in 2019. China and the Russian Far East certainly have natural complements – the remote Russian region has the world's largest natural gas reserves while China is one of the world's largest natural gas consumers. India and Japan, however, are also firming as major sources of gas demand.

President Vladimir **Putin** potentially stands to gain by inflating Russia's relationship with China. Putin could be, for example, playing off India's desire to weaken the Sino-Russian relationship in order to drum up investment in the region. Driving growth in the Far East has been a priority for Putin after recent rumbles of anti-Kremlin sentiment. However, the fact that no formal contracts have been announced even after Modi offered Russia a US$1 billion credit line to develop the region in 2019 means that, as yet, there are few tangible outcomes to show.

COVID19 accelerates eastward economic shift

China's early economic recovery helps Beijing notch several economic milestones

Since the beginning of this century – and especially since the Global Financial Crisis – the world's economic centre of gravity has been inexorably shifting eastward. Asia's, and particularly **China**'s, superior handling of the COVID19 pandemic vis-à-vis the West has only sped up this trend. According to the UN, 2020 was the first year in history that China attracted more foreign direct investment (FDI) than the **US**. FDI into the US plunged an alarming 49 percent to US$134 billion, compared to China's figure of US$163 billion. COVID19 is far from the only explanatory factor here, with the Trump administration's trade and investment policies having severely limited inbound Chinese investment into the US.

In what was another significant economic milestone, China also overtook the US as the **EU**'s top trading partner. Across 2020, the EU's exports to China increased by 2.2 percent, while imports from China rose by 5.6 percent. The bloc's exports to China are dominated by a few countries – **Germany**'s exports to China make up 48 percent of the EU's total. Significantly however, China's status as the EU's top trading partner is far more driven by Chinese imports to the EU rather than European exports to China. The US and indeed the **UK** are still bigger markets for the EU than China. China's growing emphasis on self-reliance and its new dual-circulation strategy – essentially an import substitution policy – means that this dynamic may not change for some time.

Rare earths and supply chains of other critical goods firm as key area of Sino-US friction

Recent moves suggest clear opportunities for countries including Australia

According to a recent report in the *Financial Times* – itself relying on anonymous Chinese government sources – **China**'s Ministry of Industry and Information Technology is canvasing restricting rare earth exports to the US. The Ministry is said to have proposed draft controls on the production and export of 17 rare earth minerals. This comes after Beijing promulgated a New Export Control Law late last year which theoretically allows for export controls on any items related to the "maintenance of national security and national interests".

The **US** has responded swiftly. On 24 February, President **Biden** signed an executive order directing a broad review of US supply chains for critical materials. The one hundred day review will cover rare earths in addition to semiconductors, large-capacity batteries and pharmaceuticals. The first step will involve assessing the US' levels of dependence on other countries before ultimately working will allies to enact countermeasures. In rare earths, this will likely mean enhanced engagement with **Australia**.

Obviously, announcing a review is the easiest part of this process. Designing supply chains with geopolitical rather than efficiency motives in mind has the clear potential to drive up costs. How far the Biden Administration goes in prosecuting this agenda will serve as a key illustration of how it will balance short-term economic with longer-term geopolitical imperatives.

Growing UK-Japanese partnership irks China

Post-Brexit Britain's partnership with Japan has gone from strength to strength

As the **UK** looks to revive its global status and **Japan** seeks a multitude of partners in countering China's rise, the two nations' bilateral relationship has enjoyed something of a renaissance. As well as signing a free trade agreement late last year, the two countries recently announced plans for joint military exercises when the UK deploys its HMS Queen Elizabeth aircraft carrier to Asia later this year. London has welcomed Japan's quest for greater cooperation with the exclusively Anglo Five Eyes intelligence community, while Japan has backed the UK's application to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) trade agreement.

The strengthening Anglo-Japanese partnership has not been well received in China, where history often colours perceptions of international relations. Though the 1902-23 Anglo-Japanese alliance was primarily aimed at **Russia**, it allowed both countries to consolidate their spheres of influence within occupied China. The uptick in UK-Japan ties has coincided with a marked downturn in the UK-**China** relationship. Unlike in other instances where China has strained bilateral relationships, Beijing actually seems genuinely concerned about its worsening relationship with the UK. A report in the *Nikkei Asia* suggested that China is particularly worried that growing Anglo-Japanese cooperation will complicate its own bid to join the CPTPP. According to one anonymous Chinese trade official, Beijing is counting on **New Zealand** – which recently upgraded its free trade agreement with the Asian giant – to help champion its CPTPP membership push. According to CPTPP rules, the admission of new members to the trade pact requires unanimous consent. So long as **Australia** remains subject to coercive trade measures, it is very difficult to see Canberra consenting to Beijing's membership application – irrespective of any pressure that may come from across the ditch.

Can the US and China cooperate on climate change?
China appears to be suggesting that cooperation may come with strings attached
Climate change is quickly emerging as one of President **Biden**'s Administration's top priorities. So too of course, is managing **China**'s rise. However, whilst Biden recently warned Beijing to expect "extreme competition" from the US, he has nonetheless advocated joint cooperation on health security, weapons proliferation and of course, climate change. Neatly compartmentalising these competing priorities was always going to be a tall order. Recent comments by Chinese officials seem to confirm this.

In late January, Biden's Special Envoy for Climate Change John Kerry sought to publicly rule out fears that the US would make concessions to China in exchange for climate cooperation. Speaking in response to Kerry's comments, China's top diplomat and Politburo member Yang Jiechi warned that climate could not be separated from other issues "unlike flowers that bloom in a greenhouse despite winter chill." Jiechi went on to highlight US "interference" in Hong Kong, Tibet and Xinjiang as a particular grievance.

Where this leaves Biden's plans remains unclear. Tackling climate change is undeniably in China's self-interest and it is Dragoman's assessment that Beijing's 2060 carbon net-neutrality pledge is serious. A base level of US-China cooperation on climate may thus be inevitable. However, if the US wants a united front with China on climate – think for example, pooling climate finance, coordinating at COP26 and jointly pressuring climate laggards – then the price in terms of concessions would likely by much higher than it would be willing to pay.