Competition for Commodities: China and the North American Response

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Good morning. It is a pleasure to be in Toronto today to discuss China and its quest for commodities. As China's rise accelerates from a backwards, third-world nation – which was its status only half a century ago – to a world economic and political super-power, questions are frequently raised today about the international consequences of China's growth. The U.S. and Canada should be working together when it comes to China, a suggestion which is supported by a recent Ipsos-Reid study indicating that 54 percent of Americans and 40 percent of Canadians agree that "the emergence of China as a superpower is a threat to world peace." That level of concern should translate into a healthy U.S.-Canadian dialogue about where this is all going.

I welcome today's discussion since China has played, and doubtlessly will continue to play, a growing role on the world stage and in the domestic agendas of many countries. And I hope such awareness will increase and dialogue will continue between our governments, and other organizations, regarding the consequences associated with a rising China.

China's emergence in the global arena presents tough choices for policymakers in most developed nations. The U.S. is no exception and I am sure Canada struggles with many of the same challenges. China presents opportunities while at the same time it poses tremendous problems – intellectual property piracy is one such example. On the one

hand, China's rapid growth provides some sectors of American industry with the opportunity to export goods and services for sale to China. This would include agricultural exports and certain professional and financial services. Other American business sectors increase profit by selling goods manufactured or assembled in China back to the U.S., displacing domestically produced products and negatively impacting American jobs. Such items include machine tools, electronics, and furniture.

On the other hand, China is not playing fair in global trading and its trade policies and practices are harming many American industry sectors. In fact, those same companies that are enjoying increased exports to China, such as Boeing, will likely suffer in the future when the Chinese learn how to reproduce the American products, some of which may be vital to American national security. And, of course, firms that are outsourcing their work to China or selling Chinese products in the U.S. contribute directly to our troubling and rapidly growing trade deficit with China.

We must think strategically when it comes to China -- look ten, fifteen even twenty years down the road and make the tough decisions today, even if this costs immediate financial or political gain in the short-term.

One area that does not require much foresight is China's current quest for commodities. And there are two problems here, which I do not think are getting the required focus. First, China is supporting many problematic regimes by entering into contracts for their nations' commodities. Second, North Americans should recognize that as China secures contracts in such countries, and others, we may be forced to pay high prices for or even be shut out from purchasing such commodities when our defense and commercial industrial bases need them. Better understanding needs to be developed now.

China has an enormous appetite for commodities to fuel its rapid growth. Imports of nickel, copper, gold, and, of course, oil are in high demand – and China is willing to do just about anything to obtain them. This includes seeking contracts with countries of

concern such as Burma, Cuba, Iran, Sudan, Syria, and Zimbabwe. As we wrote in the U.S.-China Economic and Security Review Commission's 2004 Report to Congress:

> China has entered into energy deals with a number of countries of concern, including Iran and Sudan. These arrangements are troubling, especially to the extent they might involve political accommodations and sales or other transfers of weapons and military technologies to these nations. In sum, China's growing energy demands, particularly its increasing reliance on oil imports, pose economic, environmental, and geostratigic challenges to the United States.

My discussion this morning will focus primarily on Chinese efforts to secure oil and gas, especially from problematic countries, and how the U.S. is seeking to address this issue. Again, this is not an easy task for policy makers, as noted in last year's report:

> Proper U.S. policy in this area is a complex calculation given conflicting dynamics. On the one hand, improved energy efficiency and bringing China into the international energy system could help manage oil prices and oil crises, mitigate environmental degradation, and potentially mitigate China's outreach to certain states of concern like Iran and Sudan (and any associated weapons proliferation involved). On the other hand, it will make China's industrial base more efficient, thereby enhancing China's manufacturing competitiveness with the United States…[and] may reduce U.S. energy leverage in the event of any U.S.-China conflict.

But first, let me comment on certain U.S. sanctions policies toward problematic countries. In connection with some countries of concern, Congress has passed legislation aimed at punishing foreign companies that do business with certain terrorist-sponsoring states. One is known as the Iran-Libya Sanctions Act (ILSA) which goes beyond sanctions directed at U.S. firms that participate in Iran, a country deeply involved in terrorism and WMD acquisition. Under ILSA, *foreign* companies can also be penalized

by Washington for investing $20 million or more in the energy sectors of Iran and Libya.

Unfortunately, this act generally has been ineffective and poorly implemented by the Executive Branch, which is reluctant to impose penalties on firms based in friendly countries, such as those of Europe and Japan. Additionally, prohibitions on U.S. firms doing business in Iran or Libya, for example, have been easily circumvented by U.S. firms forming foreign subsidiaries to participate in those economies. These are common situations.

There has been increasing concern about foreign firms that operate in other terrorist-sponsoring nations, such as Sudan, and calls for limiting or prohibiting their access to our capital markets. Congress is especially concerned about allowing foreign companies working in Sudan to access our financial markets and has introduced legislation to address this issue. The legislation, known as the *Darfur Genocide Accountability Act of 2005,* has numerous cosponsors and would call on the Executive Branch to prohibit any commercial entity engaged in Sudan from raising capital in the U.S.

But the lesson of the current ineffectiveness is that without multilateral sanctions and multilateral prohibition regimes that are enforced, unilateral U.S. legislation will not work.

This has led to further efforts in the U.S. to begin security-minded shareholder activism at the U.S. state government level, requiring full disclosure of holdings of companies that do business with these problematic countries in public pension funds, particularly with the intent of trying to divest the holdings of particular firms which are judged as too risky. The idea is that if a particular stock holding is determined to be lacking in transparency and if that firm is doing business in Sudan, or Iran, for examples, it may lose its value when its activities are exposed. Therefore the public pension fund managers are being encouraged to divest these types of holdings as poor financial risks for their clients.

Louisiana has passed legislation which allows, but does not require, public pension funds to divest themselves of any investments linked to the terrorist-sponsoring states of Cuba, Iran, Libya, North Korea, Sudan and Syria. It does require the funds to issue semi-annual reports on investments in corporations that do business in those nations. Illinois has passed legislation prohibiting investments in companies dealing with Sudan and New Jersey is considering similar legislation. Comparable bills are pending in other states. Both the New York City firefighters and police retirement funds and the California Public Employees Retirement Fund are now looking at their holdings, stock by stock, for these types of issues instead of blindly accepting the offerings of external asset managers. Additionally, Harvard University has recently divested its investments in Chinese companies doing business in Sudan. Stanford University will likely do the same.

The concern for good cooperate governance, full disclosure and transparency, which have become important in the U.S. since the ENRON and World Com scandals are being transferred to international stocks of companies operating in states that pursue WMD and ballistic missile technology and/or support terrorists. Their access to U.S. capital markets is, and has been under growing scrutiny. In 2000, China National Petroleum Corp.'s subsidiary, PetroChina, was forced to downgrade a $10 billion initial public offering in the New York Stock Exchange by over 70 percent due to broad-based protests over that company's involvement in Sudan.

The searing memory of the 9-11 attacks on the U.S. underscores in bold the importance we place on not funding companies, or their subsidiaries or parent companies, that support or promote terrorist activities, through business dealings, against the U.S.

In this respect, China is a continuing subject of concern for the USCC. Each year we have a hearing on China's proliferation policies and practices. Let me quote a recommendation we issued after our March 2005 proliferation hearing:

> The access of the [Chinese] parent firms, and the access of all entities under their control, to U.S. markets (including capital markets),

technology transfers, and U.S. grants and loans should be linked to the proliferation records of their subsidiaries.

We must aim to be more effective in issuing hard-hitting and coordinated sanctions to keep China's companies from supporting problematic regimes.

China's Commodity Market Participation

Some analysts look at China's global push for commodities and the high prices it is paying for them as a sign of weakness and national insecurity. According to these analysts, China does not see the international system as being in its favor and thus it engages in a constant quest for vertical integration and control. China's actions appear to be based upon the assumption that commodity prices will stay high indefinitely. But China could be left holding vastly inflated contracts if prices collapse.

Other analysts say that the supply security and political alliances these types of investments bring are worth the high prices China is paying. China's global equity investments in commodity exploration and production (E&P) are not entirely profit motivated. According to this school of thought, China's interests are geopolitical in nature. As a result, the Chinese are willing to pay a premium for commodities to gain political favor and long-term strategic energy and commodity placements.

Energy Commodities

China's oil demand is expected to reach 12.8 million barrels per day (mbd) by 2025. Whereas the U.S. has shifted from an oil import strategy that was based upon controlling the oil at its source to one that is based upon global market supply and pricing, the Chinese strategy is still focused upon gaining ownership of the oil to be imported at the point of production. Geopolitically this could bring U.S. and Chinese energy interests into conflict. In short, the U.S. strategy is premised on there being plenty of oil available for purchase on the world market, while China wants to own every barrel it anticipates

needing and importing. To protect these supplies, China is employing the methods of past imperialist powers. Latin America is an example of how Chinese mercantilism is assuming a neo-colonialist pattern in which a dominant country secures markets for its manufactured goods in exchange for raw materials from its weaker partners.

China's comprehensive energy strategy consists of reducing demand, diversifying sources, leveraging bilateral relationships with key Middle Eastern, African, and Latin American suppliers, building stronger ties with Russia, and establishing a market position in Central Asia. But ultimately China wants to limit dependence on foreign sources, and is engaged in energy efficiency and alternative fuel research and development (R&D) programs. How serious and how successful China will be in such alternative strategies is an open question, as it has been in the U.S.

China also needs energy supply security for continued rapid economic growth that is necessary to maintain domestic social and political stability and to keep the Chinese Communist Party in power. While there are sufficient current and near-term global oil and gas supplies, and oil and gas make up only 28 percent of China's current energy consumption, China's supply insecurity is substantial because of increasing dependence on tanker-delivered Middle East oil. Today more than half its oil imports travel via sea-lanes controlled by the U.S. Navy.

China's bilateral approach to securing its imported petroleum supplies renders it vulnerable to non-market reciprocity demands, such as political support, arms sales and WMD-related technology transfers to states of concern. Like the U.S., China needs a stable Middle East for energy supply security. This convergence of interests may either bring China and the U.S. closer in a cooperative sense or lead to competition for influence in the Middle East. No institutional arrangements for sharing surpluses and reducing competition are in place or being actively negotiated, much less implemented.

The U.S. can influence China's energy policy through technology and diplomacy. Technologically, Washington could assist China to implement clean coal technology;

participate in coal bed methane exploration and production; conduct joint R&D; and provide assistance in conducting waste-to-transportation fuel programs. Diplomatically, Washington could promote fuller integration of China in the international oil security system.

I would now like to spend a few moments addressing China's energy acquisition policies in the Americas, where China takes advantage of the apparent lack of a comprehensive, updated U.S. foreign policy toward much of the region.

As we all know, China is seeking energy resources in Alberta, and this could introduce some friction between the U.S. and Canada. Canada now is ahead of Saudi Arabia, Mexico, and Venezuela as the number one U.S. oil supplier, with 1.6 mbd (15% of U.S. oil imports). Canada's former energy minister, Murray Smith, estimated that Canada's exports will soon increase to 3 mbd, of which 1 mbd might go to China. Chinese representatives are discussing construction of new seaports in western Canada to facilitate this increase.

Canada is already producing 1 mbd from its oil sands and is expected to reach 3 mbd by 2010. A Canadian pipeline company is offering China's Sinopec a 49 percent stake in a $2 billion, 720-mile pipeline from Alberta to the coast of British Columbia. 80 percent of the oil carried by the pipeline will go to China.

Alberta has 300 billion recoverable barrels of heavy and sand oil and more than another trillion barrels if extraction technology improves. This would be enough to cover all U.S. requirements for the next 100 years at current levels, ending its Middle East dependence. China's growing influence over Canada's oil resources raises long-term strategic questions of importance to both Ottawa and Washington. The two capitals should work more closely to keep North American resources in North America. Certainly the importance of U.S.-Canadian cooperation, given Canada's resources, should be a high priority for the U.S.

China's global quest for energy is also leading to Latin America, where China is focusing primarily on Venezuela, one of four main oil providers to the U.S. Venezuela is pumping about 2.6 mbd, 60 percent of which currently goes to the U.S. But this may change. China already operates two oil fields in Venezuela. In December 2004 Venezuela's President Hugo Chavez said that China would be allowed to operate 15 mature oil fields, which could produce more than a billion barrels over their lifetimes. Chavez has also invited Chinese firms to bid on gas exploration contracts. Besides the development rights in the 15 oil fields, China will also build refineries in Venezuela, and Chavez invited China to help in establishing a government-owned oil corporation.

Currently Venezuela and China are looking to improve movement of oil to Pacific transfer points. A pipeline across Venezuela and Colombia to a deepwater port is being considered.

In the energy arena, Cuba normally attracts less attention than the traditional oil-rich states. But on Christmas day 2004, Fidel Castro announced that two Canadian companies working in the Gulf of Mexico had discovered reserves of 100 million barrels in Cuban waters. The discovery could have some significance for the U.S., for which the Gulf of Mexico is one of the largest sources of oil. U.S. companies are prohibited from drilling in waters 100 miles from Florida, but foreign companies are active there. The discovery, according to one expert, is a "virgin exploration province right in the backyard of the U.S."[1]

China has had a trade and intelligence relationship with Cuba for some time, and the discovery of oil (particularly if the amount is significant) will probably increase Chinese involvement in Cuba.

China's search for oil is also leading it to the Middle East and Africa. This includes working with the Iranians and Sudanese.

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[1] Simon Romero, "Oil Find Hints at Less Dependent Cuba", *The New York Times* (January 11, 2005).

Iran supplies 13.6 percent of China's oil imports. China needs oil and Iran (whose population has doubled since 1979) needs Chinese consumer goods. In October 2004 the two signed a preliminary agreement (MOU) worth $70-100 billion, whereby China will purchase oil and gas and develop Iran's Yadavaran oil field. China is also competing with other countries to develop Iran's large Azadegan oil field. Moreover, Sinopec, in partnership with Shell, is bidding for flows of Iran's oil.

Iran is the world's fourth largest oil supplier, behind Saudi Arabia, Russia, and the U.S., producing approximately 4 mbd. It is also one of China's top oil suppliers, behind Saudi Arabia, Oman, and Angola. Iran has four of the 21 largest oil fields in the world, and it ranks second globally in reserves with around 130 billion barrels estimated to last 93 years. It has the world's second largest gas reserves.

If the MOU for the Yadavaran development project is finalized, China will be one of the largest oil and gas investors in Iran, overtaking Japan and the EU. Oil and gas trade between Iran and China is crucial for China's short-term economic development as well as its national goal to double its GDP in ten years.

Under the terms of the Yadavaran MOU, Iran would allow Sinopec to develop the oil field in exchange for agreeing to buy 10 million tons of Iranian liquid natural gas (LNG) per year for 25 years. If the MOU becomes a final agreement, deliveries would not start for five years as Iran needs to build facilities to super cool the gas and to obtain ocean-going tankers.

The Yadavaran deal could grow to $200 billion. Earlier, in March 2003, Zhuhai Zhenrong Corp., one of China's four state-owned oil traders, signed another MOU to import 110 million tons of Iranian LNG over 25 years at a cost of $20 billion, starting in 2008.

The Yadavaran deal is considered to be a major blow to (and a clear violation of) the

effectiveness of U.S. economic sanctions under the Iran-Libya Sanctions Act, which calls for penalizing foreign companies that invest more than $20 million in Iran's oil and gas industry. And, according to President George W. Bush, the U.S. is trying to convince China that it may not be "able to sustain the patterns of trade needed for strong economic growth and continued inward investment" if Chinese companies continue to export WMD-related technology to Iran.[2] But if China's support to Iran in return for oil is to be curtailed, it will only occur if there is a strong multilateral agreement to do so, backed up by operational commitments and the application of effective multilateral sanctions, if necessary. Nothing of this kind appears likely in the foreseeable future.

Sudan is another area of interest for China's energy acquisition policymakers. According to one account, "China obtains 6.9 percent of its oil imports from that African country. In the past five years, Beijing has developed several oil fields, built a 930-mile (1,512 kilometer) pipeline, a refinery and a port. By far, Sudan represents China's largest overseas investment, worth three billion U.S. dollars."[3] Sudan may have Africa's greatest unexploited oil resources and China is well positioned to access them.

Unfortunately, China is Sudan's largest supplier of arms. Sudan, Africa's largest country and continual "problem child," receives from China billions of dollars of investment, oil revenue, weapons, and diplomatic support. Sudan's oil fields are dominated by the Greater Nile Petroleum Operating Co., and China National Petroleum Corp. owns 40 percent of that company, the single largest share.

Metals and Minerals

Monitoring and managing the oil issue is arguably the most important, but not the only, commodity-related issue on which the U.S. and other nations must concentrate. China's economy also is an enormous factor in global mineral and metal prices and its mineral and metal acquisition efforts may pose future problems for the U.S., and Canada.

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[2] David A. Sanger, "U.S. is Punishing Eight Chinese Firms for Aiding Iran", *The New York Times* (January 18, 2005)(Quoting President George W. Bush).

[3] "China's Oil Ties to Sudan Force it to Oppose Sanctions", *The Sudan Tribune* (October 20, 2004).

Unfortunately, I do not think that policymakers in Washington or Ottawa are focusing on the potential problems of China's goals of securing long-term mineral and metal deals.

Over 90 percent of China's industries, including defense industries, require nonferrous metals. Copper, for example, is used in a myriad of industries, especially the manufacture of electronic components and communication devices. It is an extremely important commodity for defense industries.

As discussed in the context of energy acquisitions, China's growing relationships with problematic African regimes should also be noted carefully. According to the economist David Hale, "China currently wants every raw material known to man, and Africa is a treasure chest of such materials." As I mentioned earlier, China and Sudan are forging a close relationship and the same is true with Zimbabwe. This relationship is revolving particularly around the mineral trade. Evidently China has no qualms about supporting Zimbabwe, which, despite its corrupt regime and crippled economy, has large gold, platinum, and chromium deposits.

Last fall China and Zimbabwe announced that they would be increasing trade in an number of fields, including "mineral industries." China gets minerals and diplomatic support while Zimbabwe gets hard currency, military equipment (in fact, China has reportedly provided Robert Mugabe with jamming devices to quell opposition party broadcasts), and a degree of relief from international pariah status. According to one western diplomat speaking with *The Christian Science Monitor*, "[s]uffering under the effects of international isolation, Zimbabwe has looked to new partners, including China, who won't attach conditions, such as economic and political reform" to their relationships.[4] The growing ties seems to be paying off for China too, as a Zimbabwean cabinet official noted that Harare supports Beijing's recent passage of its so-called anti-secession law against Taiwan.

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[4] Abraham McLaughlin, "A Rising China Counters U.S. Clout in Africa", *The Christian Science Monitor* (March 30, 2005).

Going Forward

As China continues to grow it will seek commodity contracts that will affect the U.S. and Canadian economies and national security. Those contracts will likely affect the lives of the populations living under repressive rulers in countries that are sources of the commodities. In the interest of our own economic and national security, and in the interest of those suffering in countries like Sudan, we must spend more time focusing on China's role in global commodity markets.

First, Washington and Ottawa should be setting aside short-term economic interests to focus on the long-term problems affiliated with China's commodity acquisition policies. The level of attention and dialogue must be raised.

Second, we must encourage our policymakers to develop commodity acquisition policies that will reduce our own reliance on sources in countries outside North America, as such countries may increasingly be willing to sell their resources to China instead of to us or to play the U.S. off against China. We should also be limiting China's involvement in our domestic commodity production efforts while at the same time increasing sales between the U.S. and Canada. Allowing China to influence the disposition of our strategic resources for short-term economic gains is foolish. At the same time, we should be encouraging the Chinese to develop potential domestic energy sources, including implementing clean coal technology. This of course should be done in accordance with international environmental goals. We should also promote China's integration and active participation in the international oil security system.

Third, we must be willing, as some have called for, to increasingly bring attention to China's practice of entering into contracts which prop-up corrupt and repressive regimes. Moreover, we should pursue strong and effective multilateral sanctions aimed at punishing Chinese companies doing business directly, or indirectly through subsidiaries, with problematic countries. This would involve a major new diplomatic effort by the U.S. and Canada.

The U.S. and Canada, given our long-standing cooperation and common interests, are well positioned to increase that cooperation and coordination in connection with commodities. We should develop policies to protect American and Canadian long-term interests and to promote our commitments to global human rights and to democratic governance.