 Merceritilism, Middle Eastern Empire and China’s National Oil Companies: Implications for U.S. Policy

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Many have contended that the pursuit of natural resources has fueled international conflict, and some have supposed that China’s growing hunger for fossil fuels is portending just such a conflict in the future, even describing the expansion of Chinese National Oil Companies into regions like Sudan and Darfur as a direct geopolitical challenge to the United States. This paper proposes an alternative explanation of the overseas expansion of Chinese National Oil Companies, ultimately contending that market conditions, not politics, dictate the behavior of Chinese National Oil companies. In developing this argument, this paper outlines the domestic and international market conditions that limit domestic expansion and encourage overseas expansion, the industrial organization of Chinese National Oil Companies, the bureaucratic structure of Chinese regulatory agencies, and the influence of the Chinese energy policy making apparatus. This paper concludes by proposing different policy measures that could be taken to heighten cooperation on issues of energy and energy security between the United States and China.

INTRODUCTION AND OVERVIEW

Marx famously began the Communist Manifesto by summing up all of history as a class struggle waged over control of the means of production (Engles, Marx, 1848). Certainly one important production input, oil, has caused its fair share of conflicts in the past: in one recent bestseller, Stephen Kinzer argues that one of the principal reasons that the British and U.S. inspired a coup against Iranian prime minister Mosadegh was because he nationalized the Anglo-Iranian Oil Company (Kinzer 2003, 2007).

If one were to expand one’s view of conflict to include nations struggling to control and deprive others of resources using economic (rather than military) means, then the number of conflicts over oil is nigh incalculable. In both the past and present, nationalization of foreign oil assets by domestic governments has been common (CB, 1990; Hidy, 1950; BBC, 2007), and “Regulations of commerce in petroleum by foreign governments were as specific and more numerous than those by the American states... customs duties were almost universal” (Hidy, 1950, p. 9-10). Specific historic examples of nations feuding over this “means of production” include the founding and market manipulations of the Organization of Petroleum Exporting Countries (OPEC), the petropolitics of Hugo Chávez, early protectionist tariffs in Greece and Russia, and direct repulses to American oilmen. For example, “Standard Oil’s efforts to buy petroleum-producing properties in the Netherlands East Indies were blocked by intervention of the Dutch Colonial Minister in 1897, and opposition of the Viceroy of India later kept American enterprise out of crude-oil operations in Burma” (CB, 1990, p. 1; BBC, 2007; Hidy, 1950, p. 8-10). These policies highlight the importance of mercantilist (or dirigiste) policy in dictating historic government involvement in the oil market. Jeffery Frieden and David Lake (2000) offer a useful overview of the mercantilist (what they call Realist) theory:

It is the emphasis on power that gives Realism its distinctive approach to international political economy. While economic considerations may often complement power concerns, the former are, in the Realist view, subordinate to the latter. Realists allow for circumstances in which nation-states sacrifice economic gains to weaken their opponents or strengthen themselves in military or diplomatic terms. (p. 12).

With this historical and theoretical perspective, it is no surprise that much has been said about the assertive, statist ideology that encourages Chinese petroleum firms to engage in unfair practices in international oil markets. These criticisms fall largely into two camps: one, voiced by western firms, is that China’s national oil companies (China National Petroleum Corporation, Sinopec, China National Offshore Oil Corporation and Sinochem collectively known as the NOCs) unfairly compete, leveraging Chinese state influence.
to “lock in” oil through equity contracts with other nations, securing it for exclusively Chinese use and development. As The Economist put it in a special report on China’s quest for oil, “Western companies fret that the Chinese state-owned firms with which they suddenly find themselves competing have an agenda beyond commercial gain” (The Economist Special Report, April 2008, p. 4). The second vein of criticism directed toward the NOCs’ ventures into international oil markets; one perhaps even more alarming from a government policy perspective, is the claim that China is seeking bilateral oil treaties in order to encourage political and possible military alliances with autocratic nations, creating a threat to U.S. strategic interests and potentially national security. Gal Luft (2004), executive director of the Institute for the Analysis of Global Security and one of the most outspoken critics of China’s NOCs, put it thusly: “Sixty-seven years ago, oil-starved Japan embarked on an aggressive expansionary policy designed to secure its growing energy needs, which eventually led the nation into a world war. Today, another Asian power thirsts for oil: China.” The seeds of what could be the next world war are quietly germinating” (p. 1). Another article by Edmund Keller (2007), Professor of Political Science and head of the UCLA Globalization Research Center-Africa states:

Now it is China that poses the greatest threat to Africa’s ability to promote democracy and human rights... [Western states] see China’s involvement in Africa as particularly threatening to concrete democratic process, economic development and poverty alleviation (p. 51).

Henry Kissinger has also argued that competition for oil will be the driving source of international conflict in the near future (Financial Times, 2005). When viewed from afar, the current actions taken by Chinese NOCs certainly look like a mercantilist grand strategy planned from Beijing in order to secure long-term oil concessions and strategic partnerships in rogue states (Syria, Iran, Sudan). In fact, many would argue that the oil contracts Chinese firms make also pose a threat to U.S. strategic posture and perhaps the Chinese government will use them one day in order to directly challenge major U.S. foreign policy objectives, particularly in the War on Terror (Luft 2004; Shinn 2007). If this were true, then the overseas expansion of Chinese National Oil Companies would have immense policy implications both for over-arching U.S. strategy and in the way the United States addresses immediate policy specifics such as how to approach Sudanese sanctioning goals in the U.N. Security Council and in assessing China’s determination to acquire a blue-water navy in order to protect oil routes, particularly through the Straits of Malacca.

However, that analysis is fundamentally flawed, and this paper will contest that “conventional wisdom,” instead arguing that China’s burgeoning international oil trade does not represent a coordinated, coherent, aggressive, mercantilist policy to create a sphere of influence or undermine U.S. strategic posture in the Middle East and North Africa (MENA) region. (For a formal definition of sphere of influence as used in this paper see David Lake’s “Escape From the State of Nature.”). This paper will present evidence that Chinese National Oil Companies are driven primarily by market factors, and not by government ideology or political calculations. Particularly, Chinese firms have reacted to domestic market pressures and supply shortages by expanding internationally (Downs 1, 2007). This overseas expansion is not a Chinese government conspiracy, nor is it indicative of aggressive Chinese strategic posturing (Alterman and Garver, 2008). In fact, these market factors fundamentally constrain rather than enable the policy options of the Chinese state. Rather than happily embracing rogue states as strategic allies, Beijing engages these states reluctantly and because it has few other options economically (The Economist Special Report December 2008, p. 16). Domestic consumption is rapidly outpacing domestic productive capabilities, driving the NOCs to find international sources of petroleum, and Chinese firms have had particular success pursuing this petroleum in states where western oil companies are forbidden to operate (Rosen and Houser, 2007). If the United States truly wants to understand Beijing’s diplomatic intentions with these rogue states, then it will have to recognize that China’s bilateral relationships in the Middle East and Africa are closer to economic dependency than geopolitical posturing.

In addition to addressing these over-arching strategic policy concerns, this paper will conclude by addressing immediate U.S. policy specifics regarding Chinese government intervention in international oil markets and NOC growth strategies. Particularly important is the influence the NOCs put on China to vote against further UN action on Sudan and Iran, the possibility of China developing a blue-water navy in order to protect the NOCs’ shipping routes, (especially through the Straits of Malacca), and the threat the NOCs pose to the business model of private oil companies. These include BP, Chevron, ConocoPhillips, ENI, ExxonMobil, Royal Dutch/Shell and Total, collectively referred to as IOCs (international oil companies).

Because the political controversy surrounding Chinese NOCs is largely focused on their partnership with Middle Eastern and North African states (including Iran and Sudan), and because China currently receives the majority of its petroleum imports from the Middle East and North Africa, (MENA), and will continue to receive imports from the MENA in the foreseeable future, this paper will focus on these states while giving brief consideration to Angola, China’s largest supplier of oil (See figures 1 & 2).
DEMAND DRIVEN CONSTRAINTS: COPING WITH A PRODUCTION GAP, RISING DEMAND, STATE SUBSIDIES, AND VOLATILE OIL PRICES.

Despite all the concern centering on Chinese oil imports, China still produces much of its own oil (See Figures 3 & 4). Worldwatch ranks China as the 6th largest oil producing country in the world, pumping 3,490,000 barrels of oil per day (The Economist Pocket World Figures, 2008). However, China consumes vastly more oil than it produces, meaning that international oil imports, mostly from the MENA states, make up China's substantial oil deficit. BP’s statistical review of world energy reports that China imports 2,928,000 barrels a day of crude oil and 959,000 barrels of refined petroleum. (See Figure 5). The need for oil imports becomes even more acute when dynamic considerations are in place, as Chinese demand for oil is rapidly increasing while, “barring future discoveries” its domestic oil production has little room for expansion (See Figure 6). This indicates that over the course of the 21st century, China will most likely face a widening production gap as oil consumption outpaces the NOCs’ domestic production capabilities. This is increasingly problematic for a Chinese government that relies on oil for economic growth, and on economic growth for political support (The Economist, 2008).
National Bureau of Asian Research fellows Kenneth Lieberthal and Mikkal Herberg (2006) claim that: “China has experienced oil demand growth that has accounted for nearly one-third of the world’s total oil demand growth during the past decade, and is adding the equivalent of a medium-size country to world oil demand each year” (p. 7). Of this rise in consumption, there are two important factors: the rise in Chinese consumption of gas guzzling goods (particularly automobiles) and the increase in Chinese heavy industry (The Economist Special Report, April 2008, 1; See Appendix 1: Heavy Industry and Automobile Case Studies). China’s increasing demand for oil, combined with an inability to match consumption with domestic petroleum production, fundamentally constrain Chinese policy options. In order to meet rising demand the Chinese government is forced to allow, and in fact encourage, the NOCs to import oil from abroad and expand international downstream production (Downs, 2007).

Two economists from the Peterson Institute of International Economics, Daniel Rosen and Trevor Houser (2007) have done research demonstrating that Chinese fuel subsidies further constrain Chinese policy options by structurally incentivizing overseas expansion. They said, “With limited opportunities to increase upstream production domestically and thin or negative margins on down-stream activities because of price controls, Chinese oil companies have sought to boost reserve holdings, production, revenue, and clout by expanding overseas” (p. 22).
THE “GO–OUT” STRATEGY IN THEORY AND PRACTICE: IMPLICATIONS FOR OIL IMPORTS AND CHINESE STATE RESPONSE

These domestic demand constraints have caused Chinese NOCs to seek foreign sources of petroleum for domestic import. Historically, this has not always been the case. In fact, under Mao’s centralized economic planning doctrine, energy self-sufficiency was once a centerpiece of Chinese energy policy (Zhu, 2005). Even today the more internationally orientated NOCs often contradict domestic governmental preferences for increased spending on national infrastructure to “prop up” national oil fields like those in Daqing (Rosen and Houser, 2007). While it seems likely that the Chinese government would prefer to keep their country energy self-sufficient, the Chinese government faces a grim statistical reality. The Economist puts Chinese oil consumption at over 7 million barrels per day (b/d), about half of which it has to import (Economist Special Report, April 2008). When projected into the future, oil consumption rises even more dramatically, and it seems likely that, by 2020, China will likely import 70% of its total oil needs (Leibenthal and Herberg, 2006). The Chinese government has come to recognize that as China seeks new sources of oil to fuel its growing demand, imports from the MENA will become increasingly more important. Experts contend, “As of 2015, 70% of China’s oil imports will come from the Middle East, with other significant shares coming by tanker from Africa, by pipeline and rail from Russia, and by pipeline from Central Asia” (Leibenthal and Herberg, 2006, p. 12).

This demand side pressure for foreign oil has caused Beijing as well as the state owned NOCs to conceptualize a multi-pronged “Go-Out” strategy for developing oil in foreign markets which includes diversifying import supplies and obtaining diplomatic support from senior Chinese officials (Zhang, 2008; Leibenthal and Herberg, 2006). While Beijing does provide state diplomatic support for the NOCs, it is important to note that if there is a causal relationship between government activity and corporate activity, it flows the reverse direction, with the Chinese government bound to the will of Chinese NOCs (Sinton, J., et al., 2005; The Economist Special Report, December 2008). Key to this argument is that Beijing simply does not have the bureaucratic infrastructure to enforce such a mercantilist policy. As Downs puts it, “Where many international observers see a carefully devised strategy for the acquisition of overseas oil and natural gas assets driven from the ‘top-down,’ Chinese analysts see chaos generated from the ‘bottom-up’” (Downs, 2007, p. 47-8). In fact, the Chinese government (notoriously bottlenecked as it is) has no single overriding government body overseeing its energy policy. “As a whole, the energy policymaking apparatus has too few people at the national level and the wrong set of tools to deal with the energy challenges of a large, diverse economy. The Energy Bureau is staffed with fewer than 100 people, many of which come directly from industry. The State Energy Office has even fewer (between 30 and 40)” (Rosen and Houser, 2007, p. 18). It would make sense then that Chinese NOCs would experience a great deal of autonomy from Beijing; perhaps this is why, for example, China National Petroleum Company (CNPC) has continued to invest in Sudan even though two years ago Beijing removed Sudan from the list of countries that the Chinese government encourages Chinese firms to invest in. (Downs, 2007). This has two important implications: one, Beijing is willing to show flexibility in dealing with rogue states, particularly when pressured by the U.S.; two, perhaps since Chinese firms have invested $15,000,000,000 in Sudan since 1996, they are willing now to stay there and protect those investments even against the will of Beijing (Economist Special Report, April 2008). As the New York Times (February, 2009) has recently reported, it seems that Chinese firms are more than willing to divert from their foreign holdings if they feel they are in danger of being crippled economically.

Furthermore, even if the Chinese government had the bureaucratic capacity to leverage NOCs, one might argue that it cannot significantly manipulate them from engaging in anti-market (and hence non-profit maximizing) behaviors in order to accomplish domestic political goals, because “The profitability of the state oil companies is critical to China’s efforts to meet its long-term energy security goals while supplying a significant percentage of the total revenues realized from the struggling state sector” (Lee and Shalmon, 2007, p. 4). Importantly, the decision to expand abroad was forced by domestic pressure to boost profits and increase oil imports, not as a Chinese “grand-strategy” of world domination (Leibenthal and Herberg, 2006, p. 14). This has large strategic implications for U.S.-Sino relations. Because Beijing is fundamentally responding to domestic demand constraints and pressure from the NOCs, it should be willing to show a degree of flexibility on issues of energy security that the U.S. would not expect were China specifically attempting to undermine U.S. strategic posture. In fact, the Center for Strategic and International Studies (CSIS) recently released a paper arguing that China has shown just such a flexibility (Alterman and Garver, 2008). If this is the case, then why do Chinese NOCs deliberately do business with rogue states, particularly in the MENA?

SUPPLY DRIVEN CONSTRAINTS: HOW THE GO–OUT STRATEGY LED NOCS TO PARTNER WITH ROUGE STATES

This huge demand by Chinese firms and consumers for international sources of oil has always had the greatest potential to be met by the MENA states in the long run. This is because, “Barring stunning discoveries elsewhere, the Middle East will continue to have the largest oil reserves and the lowest production costs. Sixty four percent of proven oil reserves are
located in the Middle East, and 42 percent are in the Gulf Cooperation Council (GCC) countries” (Lee and Shalmon, 2007, p. 6). (For further analysis see Figure 7). This oil is also much easier to extract than oil in other regions of the world—taking Saudi Arabia alone: “the cost of finding, developing and producing the oil is around $3 a barrel against $7 in Brazil and $14.50 in the Gulf of Mexico” (Ford, 2004, p. 2). In addition, Saudi Arabia’s Aramco also has room for expansion. Ford estimates that Saudi Arabia could be producing as many as 22.5 million b/d by 2025 (Ford, 2004, p. 2). Lee and Shalmon (2007) argue that the need for Middle Eastern oil has driven the behavior of Chinese NOCs for the past decade: “In 1992, China imported approximately 37 percent of its crude oil from this region compared with 59 percent from Asian-Pacific countries, but by 2004, Asian-Pacific imports had fallen to no more than 12 percent and Middle East imports had risen to 45 percent” (p. 7). When expanded to include all of the MENA (instead of just the Middle East) the percentage of Chinese imports that come from the region becomes even higher, 58% of the Chinese total (Skinner, 2008).

The above portrait provides clear indication why the NOCs would seek oil in the MENA generally, but does not indicate why Chinese firms sometimes invest in areas that particularly trouble Western governments (Sudan, Syria, Iran). Some U.S. policy makers might argue that the Chinese government is forcefully pressuring its firms to engage in trade in these countries in order to create strategic alliances in the region (Luft, 2004). However, many analysts find this fundamentally unlikely, particularly since merely vetoing U.N. Security Council resolutions directed toward these states has already soured U.S.-China relations (Fromholt, 2008; Kellerhals, 2008). If China ever sought formal security relations with these states it would certainly inspire the wrath of the United States and Western Europe. China would be paying a high price for some rather unimpressive allies.

Instead, it seems that Chinese firms also face fundamental supply side constraints, often forcing them to operate in technically inferior and risk-prone MENA and Sub-Saharan drilling zones. Rosen and Houser (2007) provide insight: “Given economically comparable projects, China’s firms make decisions about where to spend their money based on three considerations: technical capabilities and (to a lesser extent) the compatibility of the oil in the ground with the refineries back home; the presence of competition from IOCs [International Oil Companies]; and an assessment of political risk” (p. 30). In fact, of these considerations, the first and third factors, technical challenges and political riskiness would seem to discourage Chinese firms from investing in MENA rouge states. Taking the first factor, it actually seems that Chinese firms have a major technological disadvantage in the region. The oil there is much more sour (containing more hydrogen sulfide and carbon dioxide) than Chinese downstream refining technology can handle in bulk (EIA China, 2008). The third factor, an assessment of political risk, would also seem to discourage large capital-intensive investment projects since the MENA is notorious for political instability. Sudan, for example, is grappling with a North-South civil war, has large displaced populations, and large-scale killings are taking place in Darfur (CIA World Fact Book Sudan, 2008). This is not to say that Rosen and Houser’s analysis is accurate, just that it seems that the second consideration (lack of competition from other IOCs) trump the first two, forcing NOCs to operate in areas like Sudan, Iran and Syria where Western governments forbid IOCs to operate.

There is a historical element to this argument that, because IOCs have already gobbled up more choice oil fields where they are readily available, Chinese NOCs are forced to pioneer new areas to develop. In the past it has not been uncommon for rising international firms to seek new primary product markets and circumvent the interests of existing firms. Nathan J. Cinto (2006), a history professor at the University of Chicago and an expert on U.S.—Saudi Relations, gives a detailed historical account of U.S. firms pursuing a similar course of action (trying to access new markets and circumvent pre-existing oil interests) beginning in the 1930’s in order to get around British and European interests in the Middle East. This, he argues, is the reason why the United States established close ties to Saudi Arabia.
This has clear policy implications. If Chinese NOCs are operating in qualitatively inferior locations in order to avoid IOC competition, then this is a further argument for the U.S. to pressure China into liberalizing its energy market, boosting NOC competitiveness. An ideal forum for this would be the U.S.-China Strategic Economic Dialogue (SED). Additionally, if the United States wants Chinese cooperation on U.N. Security Council resolutions dealing with these rogue states, then it will fundamentally have to re-organize its strategic approach to analyzing China’s bilateral relationship with these states. For China, the relationship is more economic dependency than geopolitical maneuvering.

**OTHER SPECIFIC ISSUES AND POLICY CONCERNS: MAINTAINING IOC COMPETITIVENESS, THE THREAT OF EQUITY OIL AND CHINA’S BLUE-WATER NAVY**

American oil companies often complain that it is difficult to compete for contracts when Russian and Chinese companies have the dazzling “star-power” of state authorities directly lobbying for their contracts with foreign nations (Sinton, J., et al., 2005; Kurlantziick, 2006). In order to help Chinese NOCs access the supply of MENA oil, the Chinese government has certainly helped produce lucrative oil contracts that benefit Chinese firms. Particularly, “this form of direct support means that the Chinese state directly intervenes as a negotiating partner for NOCs, offering both foreign aid and arms deals” (Skinner, 2008); and that the Chinese government attempts to create broad trading regimes in oil producing countries (Lee and Shalmon, 2007). The Chinese state can also use its clout on the U.N Security Council to “leverage its energy interests” (Skinner, 2008, p. 2).

Some analysts might take these facts and then use them to argue that the presence of Chinese NOCs in the MENA indicates a mercantilist development strategy engineered by the Chinese government (Luft, 2004). According to this line of reasoning, China’s policy threatens IOCs by providing a significant boost in bargaining power to Chinese NOCs (The Economist Special Report, April 2008). The increased presence of Chinese firms overseas may also encourage Beijing to develop a blue-water navy to protect its oil interests. Each of these points requires further examination.

**EQUITY OIL AND THE UNFAIR ADVANTAGES OF CHINESE NOCs**

People who argue that Chinese NOCs experience significant advantages over their IOC counterparts have contended that China structures trade negotiations along lines that encourage foreign governments to allow Chinese NOCs access to petroleum which is then “locked-up” in long–term equity contracts such that IOCs cannot access it (Shinn, 2007, 55; Skinner, 2008). Were this true, the implication for U.S. policy would seem to be either confront China in order to end their diplomatic assistance to the NOCs or recommend that senior State Department officials travel with American oil firms to assist in negotiations, particularly pressuring foreign governments to sign contracts, offering political favors in return—offsetting such “charm offensives” from Beijing (Kurlantziick, 2006, p. 2). Historically, this has in fact been a part of U.S. foreign policy (Cinto, 2006).

However, claims that Chinese NOCs come better equipped to bargain than IOCs because of support from Beijing may be somewhat farfetched when one considers that these NOCs are dwarfed by the sheer size and volume of oil imported into China by the IOCs. “While Chinese purchase of oil and gas assets abroad has received much attention, their total contribution to Chinese oil imports in mid-2005 was less than 300,000 b/d” (EIA.gov—China). Among this total, equity oil—the oil which has been “locked-away” from IOCs’ accounts for a particularly small percentage of it—15% of the Chinese crude oil imports, and 6% of Chinese petroleum consumption (Department of Energy, 2005).

Even more importantly, Chinese NOCs may still choose to sell the oil that they extract to other international consumers and firms. China’s downstream oil market is much less profitable than upstream development in foreign markets, particularly in the MENA. According to the Energy Information Agency (EIA): “Domestic price regulations for finished petroleum products have hurt Chinese refiners because of the large difference between current high international oil prices and low domestic rates” (EIA.gov—China). This encourages Chinese NOCs not only to expand foreign production, but also to sell the oil to foreigners, thus circumventing low domestic prices. This is exactly what we see happening with NOC oil purchased in Sudan. Although the absolute volume of oil extracted by Chinese NOCs from Sudan increased in 2006, the amount that the NOCs exported to China declined precipitously as price rose and the NOCs diverted shipments to countries without price ceilings (Rosen and Houser, 2007). This seems to indicate that Chinese NOCs are not beholden to Beijing, and that they act according to market incentives and not political ideology.

Finally, basic economic theory tells us that that even if Chinese firms enjoyed a significant boost at the negotiating table because of Beijing’s “leverage,” this may still provide net welfare benefits to non-Chinese consumers if it allows Chinese firms to access oil previously unavailable to IOCs (Economist Special Report, 2008). Rosen and Houser state that even if “every barrel [extracted by Chinese NOCs] were shipped back home, that would mean less China needed to buy from Saudi Aramco or Kuwait Oil, and thus more available for the United States [or other nations] to purchase” (Rosen and Houser, 2007, p. 33).

This analysis also has clear policy implications. Instead of “giving in” to American IOCs and asking the State Department to increase diplomatic pressure on foreign governments that do not give IOCs preferential treatment, the United States should encourage the liberalization of the...
Chinese downstream market. This ought to include allowing the IOCs to freely compete inside of China and the Chinese re-examination of domestic price subsidies. While this diplomatic effort should be closely coordinated with the State Department, the SED offers an ideal forum to raise these issues.

**The Creation of a Blue-Water Navy**

A final U.S. national security concern, briefly detailed, is that Beijing’s desire to secure its own oil routes might encourage it to develop a blue-water navy to protect these strategic interests. (Leibenthal and Herberg, 2007). Particularly motivating (according to this line of reasoning) is the fragility of Chinese oil supplies crossing through the Straits of Malacca, which the IEA claims “is the key [petroleum] chokepoint in Asia with an estimated 15 million bbl/d flow in 2006,” and that “if the strait were blocked, nearly half of the world’s fleet would be required to reroute around the Indonesian archipelago” (IEA World Oil Transit Checkpoints). China is particularly dependent on the Straits, and Xinhua (2005), a state owned Chinese newswire, reported in 2005 that 80% of China’s oil imports pass through the straits.

China’s development of a blue water navy in order to protect the Straits may or may not come true. In a case study analysis conducted by Harry Lai of the East Asian Institute, he argues that an increase in Chinese militarization of the Straits is unlikely because:

Its blue-water navy is still more of a concept than a reality. Its ability to safeguard and/or disrupt sea-lanes from the Persian Gulf to the South China Sea have been rather limited. Any disruption of sea-lanes by China would invite strong counter-moves by the other parties and could be highly counter-productive. Therefore most of China’s efforts at securing its oil routes have been to find alternative land pipelines or railway links. China also apparently falls back on US protection to ensure the safety of its sea-lanes for oil. (Lai, 2007, p. 531).

Additional concern might be voiced over the recent decision by Beijing to deploy military vessels off of the West coast of Africa in order to protect Chinese shipping from pirates. While the vote to allow the deployment unanimously passed the UN security council, this may still signify a dangerous shift in the Chinese strategy for military modernization (BBC.com, December 2008). Either way, the U.S. intelligence community should watch China’s naval developments and military spending closely.

**Conclusion**

While to an outside observer it may seem like China has recently embarked on an aggressive, expansionary foray into international diplomacy, China’s bilateral relationships with oil producing states are relationships defined by economic necessity, not geopolitical posturing. Although China’s NOCs may receive marginal benefits from the Chinese government, Chinese NOCs act in a profit-maximizing manner similar to Western IOCs. Similarly, Chinese oil interests in the MENA (and the importance of oil security to Beijing) do not inherently represent a destabilizing force threatening American security interests. This is simultaneously both a good and a bad thing. Because the Chinese government’s interest in oil security (an interest shared by governments worldwide) is not inherently hostile, this indicates that China may be willing to co-operate on issues of energy security. One step toward this cooperation should be the inclusion and increased involvement of China in the International Energy Association (IEA). Another crucial step would be to use the SED to pressure China on sensitive issues like the liberalization of China’s downstream oil market, particularly allowing American international oil companies (IOCs) increased market access. Also important is addressing China’s fuel price ceiling and subsidies. Were fuel prices allowed to rise, demand for refined petroleum would slacken, reducing the rate the Chinese production/consumption gap is expanding.

Acknowledging that China’s bilateral relationships with these states are driven by economics also complicates issues that once seemed black and white. Previously, China has stonewalled the U.N. Security Council by invoking principles rather than economic necessity—most notably the concept of sovereignty (China Daily, 2003). While this may still sometimes continue to be China’s official rationale, the United States will have to take the economic reality of the situation into account and develop new approaches to encouraging China to support American foreign policy goals like Iranian sanctions and a U.N. peacekeeping mission in Darfur. Additionally, the United States must recognize that the international presence of China National Petroleum Company, China National Offshore Oil Company and other state owned oil companies provides a strong economic incentive for China to begin developing a blue-water navy.

**References**


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Economist Special Report, a year, making China the world's second-biggest market (2006 the number of new cars sold grew by an average of 37% increased as Chinese citizens have become increasingly more tors from which demand for petroleum is derived) has

The rise in Chinese automobile consumption (one of the fac-

APPENDIX 1

WHY IS CHINA’S OIL CONSUMPTION RISING? INCREASE IN AUTOMOBILE CONSUMPTION AND HEAVY INDUSTRY CASE STUDIES.

The rise in Chinese automobile consumption (one of the fac-
tors from which demand for petroleum is derived) has increased as Chinese citizens have become increasingly more prosperous. Today, “More and more Chinese are trading in their bicycles for motor bikes and cars. Between 2000 and 2006 the number of new cars sold grew by an average of 37% a year, making China the world’s second-biggest market” (The Economist Special Report, April 2008, p. 8).

Rosen and Houser (2007) contend that this increase is a function of GDP per capita: “Chinese households are reaching income levels at which energy-intensive consumer goods, like air conditioners and automobiles, are within reach... historically, when countries reach $5,000 per capita GDP” (p. 14). (See figure A1).
The current Chinese per capita GDP is $5,300 (PPP) (CIA World Factbook—China). Sinopec also released predictions that this automobile consumption will increase in the future, “the 23m cars owned by Chinese consumers in 2005 will multiply to 130m by 2030, placing a considerable burden on a country where at least 43% of oil demand is met by imports” (Skinner, 2008, p. 2). This increase in automobile purchases (barring the invention/discovery of a viable petroleum substitute) will cause a huge increase in oil demand.

Another source of the boom in Chinese energy consump-
tion, and one that has particularly important implications for the international oil market is the structural shift by the Chinese economy into heavy industry, which has increased the overall energy intensity of the Chinese economy.

The Economist (2008) argues that there are two main rea-
sons for this increase in heavy industry. One is that China has “reached a stage in its development when labor becomes relatively scarce and growth begins to rely more heavily on investment” (p. 21). Since heavy industry is capital intensive, the relative abundance of Chinese capital—about 50% of Chinese GDP gets saved every year (Roach 2006, p. 1) means that Chinese firms are more likely to switch into heavy industry. This is (arguably) compounded as Chinese labor becomes relatively scarce, and thus the opportunity cost of not substituting capital for labor increases. Therefore, Chinese firms are more likely to switch into capital-intensive heavy industry. This argument flows along the lines of Oshima's (1987) Economic Growth in Monsoon Asia: “The passage into an industrial society is accompanied by rising yield per hectare, multiple, diversified croppings, off-farm employment, and higher farm-family incomes. With increased incomes, aggregate demand for industrial products rises, employment opportuni-
ties in the cities open up, and soon full employment is reached. Rising wages induce mechanization on farms and in firms...” (p. 315). This transition described by Oshima rewards firms that produce increasingly capital-intensive goods during the later end of this demographic transition.

Another argument, proposed by Rosen and Houser, holds that the Chinese economy’s recent and rapid shift into energy intensive heavy industry happened because heavy industry (largely state owned enterprises [SOEs]) has become increasingly profitable due to artificially low factor costs of land and capital paid by SOEs, as well as the ability by Chinese SOEs to largely ignore environmental costs and free ride off of public goods like clean air and water (Rosen and Houser, 2005). Deepak Lal, a UCLA economist who similarly believes that market distortions have allowed SOEs to compete with the private sector on unfair terms, elaborates on the Chinese financial system that over-feeds SOEs cheap capital:

The reason [that SOEs access subsidized capital] is that nearly 90 percent of Chinese household savings are placed in the state-owned banks, which channel them at subsidized rates to the low return and often loss-making SOEs. The efficient pri-

vate sector is crowded out of access to the bulk of Chinese savings... This continuing subsidization of the SOEs to meet the social burdens imposed by the past development strategy, based on promoting heavy industry through planning, is leading to serious problems of economic management and ineffi-
ciencies in the allocation of investment. (Lal, 2006, p. 6).

In other words, bankers in nationalized Chinese banks often loan capital at a below market or negative real interest rate to their friends in Chinese SOEs. This provides a subsidy to Chinese SOEs, making their projects (largely energy intensive heavy industry) more profitable than it would be if capital were better allocated (The Economist Special Report, April 2008).
FIGURE A1
Adopted from Rosen and Houser 2007, 14

Figure 14: Vehicle Penetration as an Income Function, including China and India Projections to 2030

China’s vehicle fleet is slated to grow from 37 million today to more than 370 million in 2030.

Source: Jargov, Gatley and Sommer (University of Leeds)