"China in Asia" Seminar Series
Summary of Core Group discussion for April 21 seminar

The initial core group discussion focused on the issue of China's pursuit of energy security. To put the discussion in perspective, the next two paragraphs outline key assumptions underlying the "global energy market" paradigm, not all of which were actually articulated in the discussion.

Global prices reflect the balance of global oil supplies and global demand along with market expectations at any given moment. Standard long-term oil supply contracts provide a guarantee of delivery for the term of the contract (subject to "force majeure"). Contracts are usually adjusted monthly to reflect changes in global prices, and therefore do not provide a hedge against future price increases. From this perspective, the market provides supply security since buyers can always purchase the amount of oil they want at the global price; increased local demand will simply drive the global price up until global supply and demand reach a new equilibrium. In a global market, any local disruptions in supply or local increases in demand affect the price everybody pays. Oil and natural gas are usually delivered to the buyers closest to the production location to minimize transportation costs. American oil companies with long-term contracts in the Middle East therefore sell much of that oil to customers in Europe and Asia, while most U.S. oil imports come from closer sources in Latin America, Canada, and West Africa.

Equity investments, where a company purchases ownership of future output, only provide a hedge against price increases if the company sells the oil domestically at below-market prices, thereby reducing profits or incurring a loss. The cost of buying an equity stake in an oil field reflects an implicit valuation of the expected future output, with the investor assuming the risk of price fluctuations. If actual future oil prices are lower than the implicit valuation, the company will lose money on the deal. If future prices are higher than expected, the company will earn extra profit on its investment. A private company would ordinarily pass these profits to its shareholders or increase investment in future production rather than sell energy to customers at below-market prices. However state-owned firms (like China's three major oil companies) might come under political pressure to sacrifice profits by providing energy at subsidized prices, thereby undermining potential investment for the future. Because of China's rapidly growing oil import needs, most of China's oil imports are supplied by long-term supply contracts rather than equity investments.

The discussions highlighted four different potential disruptions to Chinese energy security: 1) supply disruptions caused by local political/military events; 2) transport disruptions caused by piracy or regional insecurity; 3) US political/military efforts to interdict Chinese energy supplies; and 4) demand-driven increases in energy prices.

Several economists maintained that according to the rules of the global energy market, Chinese energy strategy appears irrational and paranoid. It does not make sense to pursue ownership of resources abroad because ownership does not guarantee access. If an embargo or local conflict cuts off transportation routes, ownership of resources would not guarantee delivery. It does not make economic sense to pay premium prices for ownership when contract access would significantly reduce costs. However this has been the Chinese pattern of behavior in several resource and commodity markets since the 1970s. A resource specialist portrayed China as lacking a coordinated energy plan, following a consistent but disorganized path of behavior focused on securing oil supplies.

Participants debated potential explanations for Chinese behavior. A trade expert argued that China's strategy is perfectly rational if one does not trust anyone else in the market to provide fair prices and access. The issue was not resources, but power. Core group members appeared divided over whether China was pursuing a mercantilist approach to energy. A labor expert questioned whether China could influence global prices and secure cheaper supplies by acquiring energy supplies outright. Although economists questioned this logic, one expert nonetheless concurred that this may very well be the perception held by the Chinese leadership – that ownership and control of resources confers great power status.

A China specialist proposed that China was caught between conflicting concerns about price and security of supply, not unlike similar oscillations in U.S. energy policy. Efforts to lock up energy supplies by paying high prices for foreign investments could increase the price of energy in China, potentially reducing the competitiveness of Chinese firms. The Chinese are paying a premium for security of supply. An economist countered that ownership did not provide security against transport disruptions or U.S. interdiction.

Other core group members pointed out that Chinese energy security concerns applied not only to securing ownership of energy sources, but also to building means to transport those resources to the Chinese market. Beijing was competing for a pipeline from Russia (which they lost to Japan) and is building a pipeline through Kazakhstan. There is talk of a pipeline through Myanmar to bypass the Strait of Malacca. These efforts dovetail with other activities such as building ports in Pakistan and Myanmar and cultivating relationships with resource-rich countries in the Middle East, Latin America, and Africa.

Another China specialist noted that Chinese naval modernization has uses beyond a Taiwan contingency. Since the transport of oil and gas from the Middle East is guaranteed by U.S. naval power, China is concerned about the U.S. ability to disrupt its energy supplies. China is unlikely to match U.S. naval capabilities, but a blue water navy could potentially be used as a "risk fleet"—serving as a deterrent to a U.S. blockade and leveraging U.S. naval capabilities to keep supply routes to the Middle East open.

The discussion then turned to China's impact on Asia. If the Chinese economy slows down, how would this affect the region? How are Chinese efforts to secure supplies of energy and commodities affecting others in Asia?

In the event of a considerable economic slowdown, most participants predicted China would turn inward and focus on domestic concerns. In times of internal crisis, the Chinese leadership has historically become insular. This suggests efforts to bolster the domestic economy (in order to maintain employment and social stability) and less concern about the potential negative effects on China's neighbors. A few participants suggested that China has sometimes made damaging regional policy choices to deflect attention from domestic problems. A China specialist countered that it was hard to see how "international adventurism" would help resolve internal economic problems given China's connections to the world economy. Ultimately the leadership would focus on protecting the regime.

Most participants agreed that an economic slowdown would reduce China's regional influence. Two economists noted that Chinese inroads into Southeast Asia were not institutionalized and could reverse quickly in the event of an economic slump. China's charm offensive has highlighted its ability to provide capital and aid for major infrastructure projects, its role as a driver of regional trade and investment, and its importance as a major market for regional production. Southeast Asian countries have been willing to make short term sacrifices in order to get in on the ground floor of China's rise. Southeast Asian countries would ride out a modest slowdown in China's economy, but a severe or protracted downturn would reduce China's regional influence. In a worst case scenario, Southeast Asia could be adversely affected if cheap Chinese exports were dumped in their markets and massive waves of migrants flow across southern borders.

In response to a question about whether a slowdown in growth would reduce spending on military modernization, a China security expert expressed the view that a slowdown would have only a modest impact on the PLA budget, perhaps trimming defense spending by $1-2 billion a year.

Ultimately, as an economist pointed out, even oil that went to $70-$80 per barrel would not cause too much damage because China is not as dependent on imported energy as Japan. The biggest risk to China, and the rest of Asia, would be the indirect effects that higher oil prices would have in reducing global demand (and possibly causing a recession in the United States).

In the opinion of one Southeast Asian specialist, China's energy policy reflects the Party's overall strategic worldview. Most matters, like the Strait of Malacca and energy resources, boil down to strategic issues rather than economics. China is playing a strategic game in Southeast Asia—its goal is to establish Chinese regional supremacy (like the U.S. Monroe doctrine). At the end of the day, China would choose power over economics. Another analyst agreed that China's behavior reflected a unilateral pursuit of energy security. China participated in multilateral energy working groups, but its behavior has not really changed.

Participants highlighted the considerable variations in China's economic impact across the region. Many Southeast Asian nations are still primary product exporters; growing Chinese

demand for commodities has a positive impact on their economies. There can also be some negative side-effects, as in Indonesia, where Chinese demand is prompting illegal logging and undermining government attempts to manage resources effectively. Rising energy and commodity prices have a negative effect on some economies, but the pinch is being felt harder in Japan than in Southeast Asia for now.

Another core group member highlighted India's role as a significant regional player, both in terms of its own growing demand for energy and its naval capability. India has also been invited to the East Asian Summit.