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**Hearing: Energy Trends in China: Implications for the U.S.**

Introduction

Chinese foreign policy has changed dramatically over the course of the last decade. China pursues its interests today through a more creative and pro-active diplomacy. In addition, China has greater capabilities and a widening “tool box” available as the means to pursue its foreign policy goals. The net effect is that China is choosing deeper engagement and involvement with the outside world, and is increasingly effective at promoting its interests – even in the cases where its interests clash with the United States and other established powers.

One of the key drivers to Chinese foreign policy is a requirement to establish secure, reliable access to energy resources that lay beyond China’s borders. China’s domestic economic growth has led to a surge in demand for energy. The increased demand is primarily for oil, and it well-exceeds China’s domestic production capacity. Sustaining China’s economic growth is a vital to the regime, and thus there is a growing perception among Chinese leaders that increasing reliance on foreign energy creates vulnerabilities and risks. In order to secure the energy required to support China’s domestic demand, China’s has embarked on an effort to promote supply diversification as well as overseas equity investment.

The United States will be impacted by China’s surging demand for energy. Some of the impact will likely be negative – higher prices for foreign crude for example. It may also be the case, however, that China’s increasing reliance to the outside world presents the United States and our friends with foreign policy opportunities. My statement will address the following: observations on energy trends in China; impact on China’s foreign policy; consequences and opportunities for the United States; and thoughts on U.S. policy response.

Observations on Energy Trends in China

The top priorities for Chinese leaders are to continue to develop the country and to increase comprehensive national power. The largest element associated with those goals is to sustain China’s domestic economic growth. This reality links China to the outside world in a variety of ways, but none more evident than China’s need to import oil for the purposes of literally fueling economic development at home.

China became a net oil importer in 1993. It is now the second largest importer of petroleum in the world, surpassing Japan in 2003. The demand continues to surge. As recently as 1996 China imported 22.8 million tons of crude. By 2004, the number reached 122.7 million tons of crude. In all, China accounts for over 40% of world oil demand growth over the last four years.

Equally important, economists and energy specialists forecast that China’s requirements for importing crude will continue to grow at a fast clip. The International Energy Agency predicts that China may need to import close to 80% of its oil by 2030. The primary driver will continue to be individual energy consumers (more and more cars on the road), and energy required to support industrial growth.

China has embarked on an effort to mitigate its risks associated with its growing reliance on foreign sources for energy. Efforts aimed at developing supply diversification and acquiring equity investments abroad are driving China's foreign policy and diplomacy in tangible ways. It should be noted here that China is also pursuing efforts to reduce demand (e.g. new vehicle efficiency standards, national fuel tax), develop alternate sources (natural gas and nuclear), as well as to develop a strategic petroleum reserve. None of these efforts, however, change the fact that the Chinese economy and associated infrastructure are being developed in a manner consistent with a 20<sup>th</sup> century, petroleum-based development model. In other words, China will continue to need more and more oil if it continues on its current growth and development path despite other attempts to mitigate risk.

Coal deserves special mention. China is the world's largest producer *and* the world's largest consumer of coal. Coal still accounts for 65% of China's primary energy consumption. Its coal consumption is roughly 27% of the world total. What is important to understand with respect to future needs is that although coal's share of overall Chinese energy consumption is projected to fall (replaced primarily by oil), coal consumption will likely continue to grow in absolute terms. This links China to the outside world in a different way as compared to oil. China's coal burning takes a heavy toll on China's environment. But in fact, the environmental degradation will not be contained within China's borders as there will be increasing fallout in the region, and in the global environment if the trend lines continue.

### Impact on Chinese Foreign Policy

In the simplest and most straight-forward terms, China's surging demand for oil imports lead China to seek diversification in its supply sources, and greater ownership of overseas assets that relate to energy production and export. However, there are other foreign policy implications as well. The logistics train also needs to be secure to ensure minimal risk of the delivery of energy to China. And China is also aware that even owning oil and pipelines does not completely mitigate risk of disruption unless China has the military capability to protect assets abroad – thereby requiring power projection capability.

The goal of greater source diversification has led China to develop not only stronger commercial relations with a greater number of oil producing countries, but stronger political relations as well. As recently as 1996 (three years after becoming a net oil importer) China imported roughly half its oil from two countries – Oman and Indonesia – and nearly 70 % from three countries combined (add Yemen to Oman and Indonesia). A short eight years later, by 2004 China had developed significant import sources from Iran, Sudan, Angola, Russia, and Saudi Arabia. While a disruption associated with one of its major sources of crude oil (its largest being Saudi Arabia at 16%) would still have a major impact on the Chinese economy, its fair to observe that in less than a decade China has succeeded in spreading its risk through diversification efforts.

China is also acquiring assets, and becoming decision-making equity investors in oil producing countries overseas. According to a Jamestown Foundation China brief in April 2005, China enjoyed early success on the African continent in Sudan. Initial investment in the mid 1990s included sending large numbers of Chinese engineers and construction teams. The oil began pumping in 1999, and by 2004 Sudan was the 6<sup>th</sup> largest supplier of oil being imported by China. These efforts are mirrored globally in other developing countries. In Central Asia, according to the Eurasia Daily Monitor, China has made initial investments in Uzbekistan of approximately 106 million USD. Chinese investments may reach 600 million USD in Uzbekistan over a longer period.

China's increasing demand for oil lead to greater exploration efforts at home, as well as investment in exploration in developing countries. However, they are not limited to onshore exploration. China is also investing in offshore exploration which carries potential foreign policy consequences. Although major efforts to date have occurred in Chinese sovereign waters (the Bohai Sea in the largest project funded by China), others in the region have concerns that China's appetite might be larger. In some cases a larger appetite for off-shore exploration may lead to greater stability in Asia (e.g. China and Vietnam reached agreement for joint exploration in areas previously under dispute), but it may also tempt China to push its claims on other disputed territories. Understandably, this makes some in Japan feel uneasy after several incursions by Chinese vessels into Japanese territorial waters.

In addition to the aforementioned linkages between China's growing dependency on foreign oil and its foreign relations, there are additional effects on Chinese approaches to the outside world which, though perhaps more subtle, are nonetheless significant. China not only needs oil, it needs assurance that the oil can be delivered efficiently and safely to China. This means pipelines, secure port facilities, and maritime security. But it also means stability on China's periphery. China has secured a stunning number of border agreements on its periphery over the last decade. This also helps explain China's treatment of President Karimov a few days after the bloody crackdown in Andijon. China values stability in its neighborhood even when achieved by virtue of heavy-handed tactics.

Finally, even owning oil and pipelines does not completely mitigate risk of disruption unless China has the military capability to protect assets abroad. Thus some in China may believe that the ultimate guarantor of energy security is the People's Liberation Army. China's military modernization has been aggressive, and quite effective. Chinese military leaders have placed an emphasis on developing a "blue water Navy" and associated power projection capability. The U.S. Department of Defense report on China's military capabilities released this month states, "China's military modernization remains ambitious. In the recent past, moreover, military responses in support of Chinese claims of disputed territory or resource rights have produced crises and conflicts with China's neighbors including India, Japan, the Philippines, the then-Soviet Union, and Vietnam. In the future, as China's military power grows, China's leaders may be tempted to resort to force or coercion more quickly to press diplomatic advantage, advance security interests, or resolve disputes."

### Implications for the United States

The trends associated with China's development, its surging demand for energy, and its more pro-active foreign policy all carry implications for the United States – some direct, some more subtle, and probably some yet to be determined.

The most direct impact on the United States and our friends and allies relates to world oil prices. The health of the U.S. economy does bear some direct relationship to the price of crude. As China accounts for over 40% of world oil demand growth over the last four years, they are part of the reason we are facing high costs for oil imports in the global market. Though world reserves and production capacity suggest the market can account for China's surging demand, in the near term we are unlikely to see significant reduction in oil prices.

There may also be direct effects on U.S. and other foreign oil companies. A national-level goal to secure foreign access to oil for China will likely motivate the Chinese government to

support the efforts of “semi-private” Chinese companies in their respective commercial dealings. If the net effect is subsidized commercial bids, U.S. companies could be greatly disadvantaged.

There are other direct effects that are likely negative for the United States in the near term. These effects may fall under the header of “complicating U.S. foreign and security policy interests.” In this regard, three countries leap to mind – Sudan, Iran and Venezuela. China typically does not address human rights and non-proliferation in its relations with other countries. But the net effect in the three aforementioned countries is not simply benign neglect where irresponsible behavior is concerned. Rather, China is likely engaged in relationship-building that enables continued irresponsible behavior, and complicates the efforts of the United States and other countries to promote different outcomes. In Sudan, as we’ve worked with other countries to address the genocide in Darfur, China has continued to support the regime in Khartoum with lucrative oil deals and even arms sales. In Iran, as the EU-3 have attempted to address the nuclear challenge through diplomacy, China has continued to support Tehran with oil purchases and assurances that China won’t support action in the United Nations against Iran. And in Venezuela, as Chavez has endeavored to spread anti-Americanism throughout the hemisphere, China has given Chavez what he so desperately needs in order to sustain his efforts – lesser reliance on the U.S. market for Venezuela’s oil exports.

The growing interest in exploring disputed off-shore areas could certainly impact U.S. interests in a direct way. Many of China’s existing disputes are with friends of the United States, but in some cases, with treaty allies. If tensions continue to mount between China and Japan (and surely energy would only account for a part of the story), the United States may very well be placed in a position where we must stand-up for our treaty ally. While our generic response to matters of maritime territorial disputes is legalistic and non-committal, it’s not inconceivable we could choose a more robust response if our ally were faced with more aggressive actions from China.

The special mention of coal in the previous section should be mirrored in this section addressing impact on U.S. interests. According to the World Health Organization, seven out of ten of the world’s most polluted cities are in China. China already accounts for 13.5% of world carbon dioxide emissions. While we in the United States remain the greatest contributor to greenhouse gas emissions, as a developed, modern economy, we also have a greater likelihood of implementing policies and developing new technologies to make ourselves greener. China’s stated interest in sustainable development has not seen associated national level efforts to deal with a growing problem of severe environmental degradation in China. And these problems, as mentioned above, will not be completely contained within China’s borders.

The more subtle impact on the United States relates to how China’s emergence as a more pro-active and influential global player – very much driven by growing energy needs – will effect U.S.-China bilateral relations in the general. In other words, if the United States and China are lurching toward a classic great power rivalry, how will China’s activities in oil producing regions and oil producing countries impact our overall ability to get along with one another? As the U.S. Department of Defense report on the Chinese Military states “China faces a strategic crossroad. It can choose a pathway of peaceful integration and benign competition. China can also choose, or find itself upon, a pathway along which China would emerge to exert dominant influence in an expanding sphere...the future of a rising China is not yet set immutably on one course or another.” This is distinct from the point above about China’s potential to impact discrete foreign policy goals. This is to say China’s activities – even if viewed as negative on their own merits – will be viewed in a completely different light if we believe China is determined to choose an adversarial, competitive course with the United States.

There are many uncertainties and unknowns associated with China's energy trends as well. It is not inconceivable that China's growing reliance on the outside world for energy could actually drive us toward closer cooperation rather than competition. I would argue that China should come closer to our view on non-proliferation and export controls, closer to our view on maritime security, and closer to our view on the need to promote stability in key oil producing regions. The United States and China may be singled out as the greatest culprits in global greenhouse gas emissions, and may find common ground in addressing global concerns in ways that aren't too burdensome to our respective economies. All of this remains to be determined, however, as it is not clear that China has developed sufficient trust that the United States will be a reliable partner in these efforts. Instead, China seems to have adopted a zero-sum mentality with respect to foreign energy at this juncture. Perhaps this is temporary as they work to improve their position in the near term.

Finally, the United States may ultimately see advantage in China's efforts to develop alternate sources for energy. There is likely a lucrative market awaiting those clever enough to exploit the openings. Some opportunities are closer at hand – such as the chance to build nuclear power plants in China. Some may be in the near future as China will be compelled to seek greener technologies.

### U.S. Policy Response

From a U.S. perspective, I believe our orientation to the challenges associated with China's energy trends should consist of several elements. First, the U.S. should continue to promote comprehensive and sophisticated engagement of China. Energy is a major determinant of Chinese foreign policy, but it is not the only one. Second, we should begin to address energy security challenges in a direct, head-on manner in our bilateral relationship. There are genuine opportunities for the United States to use these trends to promote better U.S.-China relations – but the opportunities need to be harvested. Third, we should explore the creation of new modalities to address energy security at a sufficiently senior level in multi-lateral fora. And finally, the United States must hedge against the potential for a negative, adversarial relationship with China if the Chinese leadership chooses such a course.

Regarding the first element mentioned, it should be noted that although this statement primarily addresses energy, U.S.-China relations are much broader than the burgeoning competition over energy. The core elements to the policy chosen by every Administration over the course of the last 35 years are sound. To critics, a policy of broad engagement of China is more descriptive of a "process" rather than an actual "policy." But it remains true that broad, comprehensive engagement of China allows the United States to pursue our interests in areas where the U.S. and China agree, while minimizing the chance of conflict resulting from areas where we disagree. There is also sufficient evidence that our broad engagement of China has contributed on the margins to internal change in China for the better. Finally, China is not only reliant on the outside world for energy – the health and well-being of the Chinese economy is absolutely tied to foreign direct investment and for ready markets to which it can export. These are potentially sources of stability even if the drive for energy causes unease.

With respect to the second element, as stated before, China's growing reliance on the outside world for energy could actually drive us toward closer cooperation rather than competition. But this framework needs to be nurtured, and it requires pro-active efforts to build confidence, and build a productive dialogue. A senior-level global dialogue with China – as envisioned by the U.S. State Department – should include energy security. This topic was not on the Chinese wish list for

the global dialogue, but the State Department should insist upon its inclusion. Areas such as non-proliferation, maritime security, and stability in the Middle East should be on the agenda.

Third, it is insufficient if the United States and China are cooperating on energy security, but China is still experiencing tension with Japan and the rest of Asia. These issues by their very nature require multi-lateral consultation and cooperation. The United States should seek to promote an energy security agenda either in an existing multi-lateral forum – such as APEC – or seek the creation of a new forum for this purpose. Some have suggested that a Northeast Asia energy security dialogue should be constituted and sustained at a senior official level. I believe there is great merit to this proposal.

Finally, the United States must be sufficiently prepared to operate in an environment of growing competition with China. Our approach to China should be rooted in a clear vision for Asia, and a commitment to sustaining a strong bilateral alliance with Japan. It is essential that the United States adopt a force posture that is appropriate for 21<sup>st</sup> century challenges in Asia – the uncertainties related to China's strategic direction very much included. It is also essential that others in Asia, and in particular, Southeast Asia, see us as a dependable, reliable friend. We would make a mistake if we treated China as an enemy today, but we'd be equally negligent if we weren't adequately prepared to deal with the consequences of a Chinese decision to choose an adversarial path.