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Challenge or Opportunity: China's Role in Latin America

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Mr. Chairman, Members of the Committee, I would like to thank you for inviting me to brief you on China's foreign, economic and security policies, which stem from its growing energy consumption and their effects on U.S. interests in Latin America.

Since it became a net oil importer in 1993, China has traversed the globe in a relentless quest for energy sources to fuel its booming economy. In recent years its state owned energy companies concluded oil and gas deals in close to 30 countries, many of them in Latin and Central America. There is no doubt that China's robust economic growth has already been felt on the global energy scene and contributed substantially to this year's spike in oil prices that brought oil prices to reach the \$70 a barrel mark. But no less important is the impact of China's energy activities on its relations with the U.S. and the international community at large.

Energy is the main driver of China's recent international behavior. In a lecture at Beijing University in March 2004, its deputy foreign minister, Wang Yi, admitted that Chinese foreign policies are "at the service of China's economic development." And indeed, many of China's foreign policies in the Middle East, the East China Sea, Central Asia and Africa are shaped by its energy expediencies, often to the detriment of the U.S. China's recent effort to drive the U.S. out of Central Asia and its support of unsavory regimes like Iran, Sudan and Uzbekistan just because it needs their oil, are the latest testimonies of this trend.

China's pursuit of energy resources comes at a time that the world is finally waking up to the idea that oil and natural gas are finite commodities and that world demand currently and for the foreseeable future will exceed world supplies. This reality is becoming increasingly accepted by the major oil companies. Earlier this year David O'Reilly Chairman and CEO of Chevron Corporation admitted in an open letter that "the era of easy oil is over." "Many of the world's oil and gas fields are maturing," he wrote, "and new energy discoveries are mainly occurring in places where resources are difficult to extract—physically, technically, economically, and politically. When growing demand meets tighter supplies, the result is more competition for the same resources." And indeed, with global reserves of cheaply recoverable oil and gas being depleted China is

already competing with the U.S. over the same oil reserves in some of the world's most unstable areas.

Former Secretary of State Henry Kissinger warned recently that the global battle for control of energy resources could become the modern equivalent of the colonial disputes of the 19th century.

### **China's activities in the Western Hemisphere**

Of all the regions of the world where China competes with the U.S. over access to oil, the Western Hemisphere is perhaps the one where the direct impact on U.S. energy security is likely to be felt most in the long run. At the moment most of China's oil imports come from the Middle East. In 2004 the Western Hemisphere supplied only 2% of the 2.9 million barrels per day China imported. But just like the U.S. China seeks to diversify its supply sources and reduce its dependence on the Middle East. Latin America is, therefore, one of the most sought after domains. China's oil thirst has already resulted in a series of deals stretching from the southern tip of South America to the Caribbean, areas which constitute America's backyard.

- In January 2005, China and **Peru** signed a memorandum of understanding allowing China to promote investments and technical cooperation in the exploration and export of oil and gas.
- In the same month China Petroleum & Chemical Corporation, or Sinopec signed a production contract with **Cuba**.
- While U.S. energy companies have grown increasingly disenchanted with the corruption and volatile politics of **Ecuador** and its energy company Petroecuador, the Chinese seem to be undeterred from investing in drilling and exploration work there. This month EnCana, Canadian Natural Gas Company, agreed to sell oil and pipeline holdings in Ecuador to a Chinese venture for \$1.42 billion to fund debt reduction and stock buybacks.
- In **Bolivia**, Shengli International Petroleum Development has opened an office in the gas-rich eastern region and announced plans to invest up to \$1.5 billion.
- **Argentina** and China signed cooperation deals that could lead to up to \$5 billion in investments over the next decade in oil and gas exploration.
- In **Brazil**, the Chinese President signed 11 bilateral agreements, including planned investment of \$10 billion in energy and transportation in the next two years. Brazil's state-owned Petrobras and China National Offshore Oil have been studying the viability of joint operations in refining, pipelines and exploration in their two countries and in other parts of the world. This comes after a \$1 billion Brazilian agreement with another Chinese company, Sinopec, to build a gas pipeline that will run across Brazil.
- Last but not least is **Venezuela**, U.S.' fourth largest oil supplier. Since April 2002, U.S. relations with Venezuela have become increasingly acrimonious. Venezuela's President Hugo Chavez warned the U.S. against any interference with Venezuela's internal affairs threatening that Venezuela "has enough allies on this continent to start

a 100-year war," and that "U.S. citizens could forget about ever getting Venezuelan oil." This threat is not being ignored. Secretary of State Condoleezza Rice remarked in her confirmation hearing that two of her chief worries with regards to Venezuela are U.S. dependence on Venezuelan oil and whether Chavez will continue to supply it. The fissure in the relations enables China to step in and reduce Venezuela's dependence on selling oil to the U.S., which currently buys 60% of Venezuela's crude. A series of oil agreements signed in early 2005 allow Chinese companies to explore for oil and gas and set up refineries in Venezuela. Venezuela's state run oil company PDVSA opened a marketing office in Beijing and has a target of selling to China 300,000 barrels per day by 2012. But for now Venezuela's oil exports to China are much more limited. The majority of Venezuela's exports to China as of now consist of Orimulsion, a boiler fuel alternative which is burned by power plants to generate electricity. China's refineries are not equipped to refine Venezuela's crude. Geography is also a constraint. Venezuela has no access to the Pacific shore and the Panama Canal cannot accommodate the biggest tankers. A tanker trip from Venezuela to China takes 45 days. But China and Venezuela are trying to resolve these problems. In July 2004 Venezuela signed a contract with Colombia to build a crude oil pipeline connecting its oil fields with a port on Colombia's Pacific coast sparing Chinese tankers the need to traverse the Panama Canal. This could reduce the travel time by half.

Though this hearing focuses on Latin America it is important to note that China has also set its sights on North American oil. In January 2005 the Wall Street Journal reported that trade officials in **Mexico** said they see China as a potential growth market for their oil exports.

Chinese state-owned oil companies pursue ambitious deals in **Canada**, the top petroleum supplier to the U.S. Canada has emerged as the second largest oil reserve in the world due to the drop in price in the recovery of crude from the vast reserve of Alberta's tar sands. Chinese companies are negotiating the acquisition of Canadian tar sands companies and have already bought stakes in few of them. The Chinese PetroChina International signed an agreement with Canada's giant pipeline company Enbridge to build a \$2.5 billion pipeline from Alberta to the Pacific coast from where 200,000 barrels of crude a day will be shipped to China. The two countries signed the Canada-China Statement on Energy Cooperation in the 21st Century, promising to work closely in the areas of oil, gas, oil sands, energy efficiency, environment, and related ventures. Analysis conducted by Institute for the Analysis of Global Security shows that if China succeeds in acquiring portions of Canada's energy industry up to a third of Canada's potential exports to the U.S. could eventually be lost to China.

## **Implications of China's pursuit of Western Hemispheric oil**

*The single most important thing to remember about China's energy acquisitions in the Western Hemisphere is that they will eventually make the U.S more dependent on the Middle East and other volatile areas.*

The Western Hemisphere is estimated to hold 13.5 percent of the world's proven conventional oil reserves. This amounts to 162 billion barrels of which 101 billion barrels are concentrated in Central and Latin America particularly in Venezuela, Brazil, Colombia, Ecuador, Argentina and Peru. These countries accounted for 8% of total world output in 2004. Of the region's largest producers only Brazil and Ecuador still experience production growth. Conventional oil production in the rest - Peru, Colombia Argentina and Venezuela - has been declining. According to a study by the Washington based energy consulting firm PFC Energy, non-OPEC Latin America will peak around 2007 at 4 million barrels per day and will decline steeply thereafter. Considering the projection that in the next 20 years the region's own need for oil will nearly double, it seems that Latin America's long term ability to satisfy the needs of the growing U.S. market will be increasingly compromised. China's pursuit of Latin American oil will only make matters worse.

With half of its oil imports coming from the Western Hemisphere, and with oil imports projected to surge 60% during the next two decades due to demand growth and a decline in domestic crude production, the U.S. cannot afford to lose chunks of Western Hemispheric crude.

Venezuela stated recently that its aim is to supply 20% of China's oil imports. What does this mean? According to the Energy Information Administration China's oil demand in 2025 will stand on 15mbd with net imports of nearly 11mbd. For Venezuela to provide 20% of China's imports means loss to the U.S. market of 2.2mbd. In essence, every barrel of oil China buys in the Americas means one less barrel of Western Hemispheric oil available for the U.S. market. This means that the U.S. will have to look for this oil elsewhere and become more reliant on oil from more remote and less stable regions, primarily West Africa, the Caspian and, above all, the tumultuous Middle East. This is contrary to President Bush's pledge to make the U.S. less dependent on "countries that don't particularly like us." There is also a cost issue. Western Hemispheric oil is more attractive to the U.S. market because shipping costs are low relative to the Middle East and other places. The less we have of it, the more we will have to pay as a nation for our oil.

If the Western Hemisphere has any future in oil production it is in the field of non-conventional sources of petroleum such as extra heavy oil, tar sands and oil shale. By 2010 only 4% of the world's oil will come from non-conventional sources, but clearly the next several decades will show increasing role of these energy sources. About 1.2 trillion barrels of extra heavy oil are in place in Venezuela. At current technology and prices only 2-3% of this endowment is economically recoverable but it is likely that 100-270 billion barrels will eventually be economically recoverable. In Canada, there are close to 180 billion barrels which can be derived from Alberta's tar sands. Of this endowment, about

20% are economically recoverable at current market conditions. But shifting to non-conventional oil requires enormous investment and a long lead time. Furthermore, the energy required for the extraction of such non-conventional sources of crude is so huge as to offset the amount of energy the extracted oil ultimately yields. Also the cost of production is high and there are severe environmental problems. Even if production of non-conventional oil increased in proportion to the world's growing demand, China and India will seek to buy ever increasing shares of this oil, hence limiting its availability to the U.S. market.

### **Implications for the spread of democracy and the rule of law**

Latin America may not become a focus of China's diplomacy. But as long as it can offer China's booming economy raw materials and energy sources, China's foothold in the region will continue to grow and could reach a stage in which it infringes on the long standing principle in U.S. foreign policy of nonintervention in the Western Hemisphere by foreign powers. Furthermore, control of energy assets by a Communist government could expose U.S. neighbors to Chinese pressure to part ways from the U.S. on issues regarding China like human rights abuses, arms sales and mainland's relations with Taiwan. Chinese penetration into Latin and Central America could also strengthen the voices of Marxism and anti-Americanism in a part of the world critical to U.S. national security. But perhaps the biggest problem associated with China entry into Latin America is impact on America effort to promote democracy and good governance in this part of the world. In countries like Sudan, Iran, Myanmar and Uzbekistan, China's energy deals have already undermined U.S. efforts promote freedom and democracy and force improvement in these countries' human rights. Unlike the U.S., China typically does not address democracy, human rights and non-proliferation issues in its relations with other countries. Its state controlled oil companies are in a position to offer large packages of development aid which help secure them access to oil and gas assets in many cash starved developing countries. China's penetration into the Latin America could create similar problems, strengthening the region's non-democratic regimes. Chinese energy companies have another competitive advantage when dealing with the Third World, where under the table payments can ease the way to a deal: they do not have to contend with transparency initiatives nor comply with a Foreign Corrupt Practices Act.

### **Options for the U.S.**

To spare China the need to seek Western Hemispheric oil, the U.S. should encourage China to source its energy from countries that are geographically closer to it and that are not under the U.S. sphere of influence. Russia and Kazakhstan are two oil rich countries which share a border with China. Russia is today the world's second largest oil producer and supplier of 9% of China's oil imports. Earlier this month Russia's President Vladimir Putin announced that the long bidding war between China and Japan on the construction of a pipeline to carry oil from eastern Siberia had been decided in favor of China. The pipeline, scheduled to be completed in 2008, will run from Taishet to Daqing near the Russia-China border. Kazakhstan supplies only 1.1% of China's oil imports but is capable of doing much more. The two countries are soon to be connected by an 1800-

mile pipeline. China has acquired oil assets in Kazakhstan and will continue to invest heavily in the country over the next two decades. Such energy deals will create interdependence between China and its neighbors while reducing China's need to seek for energy resources in the Western Hemisphere.

Additionally, the U.S. should offer to help the Chinese to boost their domestic energy supplies, support energy market reforms, encourage regional energy cooperation, integrate China into the International Energy Agency and make it a key participant in the international dialogue on global energy policy. It should also invite China to participate in joint research and development aimed at displacing imported petroleum with energy sources that both China and the U.S. have available domestically, via utilization of clean coal technology, waste-to-liquid-fuels and advanced nuclear power stations. Such cooperation will not only help prevent future conflict but it will also foster Sino-American collaboration with significant economic benefits for both countries.

While there is an urgent need for a comprehensive energy strategy to deal with China's energy needs such a strategy cannot be based on seeking ways to block China's access to oil throughout the world including the Western Hemisphere. As a consumer of a quarter of the world's oil supply and holder of merely three percent of global reserves, the U.S. cannot afford to sit on its hands and hope that the world's energy problem resolves itself. In addition, with one of the worst fuel efficiency standards in the industrialized world the U.S. lacks the moral authority to preach to the Chinese about the need to address *their* oil problem. Nor can it ask them to deny their people the high standard of living that Americans have been enjoying for decades. The U.S. should look inward and begin to seriously address its growing addiction to oil and more broadly assign a larger role for energy policy in its global strategy.

This can only be done through multinational cooperation on energy and a joint commitment by the U.S., China and the other consuming countries to work toward reducing global oil dependence through efficiency and development of alternative energy sources.

Both the U.S. and China are not rich in oil but they are both well endowed with a wealth of other energy sources that can be used to displace petroleum in the transportation sector, which accounts for two thirds of U.S. oil consumption and the bulk of the growth in oil consumption in the developing world. Both China and the U.S. are rich in coal; both have large cities that generate huge amounts of garbage and both have massive agricultural sectors that generate billions of tons of biomass. Technology can convert all of these resources into transportation fuel. Next generation hybrid electric vehicles that can be optionally plugged in, can utilize electricity from the grid as a transportation fuel. Just as in the U.S., less than 3% of grid electricity in China is generated from oil, so using electricity as a transportation fuel would dramatically displace petroleum consumption with coal, natural gas, nuclear power and renewables.

Were the U.S. and China to collaborate on advancing such technologies and improving efficiency they could gradually curb their demand for oil and hence reduce the likelihood of conflict.

### **Seeking Latin America's sugar alcohol**

The Chinese understand what we unfortunately haven't. The answer to the energy predicament is manifestly not increased reliance on the Saudis and other members of the Organization of Petroleum Exporting Countries. Rather, it is to diversify of sources of transportation fuels. China's interests in Latin America are therefore not restricted to petroleum but also to the region's alternative fuel market. In response to its growing need for fuel China has decided to dive into the alcohol market and its main focus is sugar based ethanol coming from Brazil and the Caribbean. Brazil is the world's leading ethanol producer and exporter, distilling nearly 4 billion gallons in 2004. The country exported half a billion gallons last year but has indicated its ability to ramp up ethanol production to meet the market's need. China is already the world's third largest ethanol producer and is now in the process of developing a fleet of flexible fuel vehicles that can run on any combination of gasoline and alcohols.

El Salvador, Guatemala, Paraguay, Honduras, Colombia, Peru, Nicaragua and Costa Rica have all increased the cultivation of sugarcane for ethanol production. China has shown strong interest in these markets. The Brazilian energy company Petrobras has already started negotiations with the Chinese government to promote trade in fuel alcohol.

Should oil prices continue to soar the U.S. will have no other option but to create a fuel choice economy, as Brazil did, in which automobiles can run on fuels other than petroleum; ethanol would probably be among the most readily available of all alternative fuels. Ramping up ethanol supply requires incentives for domestic producers but more importantly it entails opening the biofuels market to imports from our neighbors in the Western Hemisphere. Today such imports are prevented due to a protectionist policy enacted by Congress which imposes stiff tariffs on ethanol imports. Oddly, we are willing to import petroleum from Saudi Arabia but not ethanol from Brazil. Blocking ethanol imports to the U.S. to protect corn growers not only undermines U.S. energy security but also has geopolitical consequences. While the U.S. could encourage sugar growers in Latin and Central America to increase their output and become fuel suppliers, creating economic interdependence with its neighbors, it is China that is doing just that.

*This is likely to make our neighbors in the Western Hemisphere increasingly dependent on China hence strengthening China's foothold in America's backyard.*

As anti Americanism spreads across the world it is critical that the U.S. maintain its strategic posture and popular support in the Western Hemisphere. This can only be done through increased effort to promote democracy, economic reforms and good governance and, not less importantly, by enriching our neighbors and promoting economic interconnectedness with them. Energy is one of the areas in which such mutually beneficial relations can be easily established.