Politics vs. Market

Mao Yushi

As China’s demand for energy grows, so does its dependence on imported oil. Currently, over 40 percent of China’s total oil consumption derives from foreign sources making a supply disruption of the oil import routes an unthinkable blow to its national economy. Oil supply security has thus become the contemporary imperative and has raised a number of critical questions. Will oil be used as a weapon against China by exporters? Will a shortage or undersupply of oil resources lead to energy wars between China and other major importers such as the United States and Japan? Politicians and scholars must think hard about these critical issues.

Shifting Landscape of Resource Competition

Since ancient times, competition over resources has been a cause for conflict. In the Han Dynasty, the Hsiung-Nu frequently invaded the central plains of China during harvest seasons for the purpose of acquiring grain and livestock. Land (one form of a resource) was also the object of intensive struggle leading to wars. Even people were seen as a resource during the slave era. All such conflict was common until the second half of the 20th Century.

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To take one stark example, the island nation of Japan has historically been in urgent need of a range of resources such as coal, iron and grain to sustain its development. Japan’s invasion of three northeast provinces in China was essentially a war to capture these and other resources that were abundant in the area.

However, this situation has slowly been transformed following World War II. With global economic integration, resources can now be distributed across world markets. Countries and companies that badly need resources can freely acquire them on the commodity markets. War and killing over resources has been rendered unnecessary. Taking Japan as an example once again, it remains a resource-poor country, yet it has achieved the status of a world economic power. It purchases all vital resource and energy needs. With the fast pace of economic development over the past few years, China’s demand for resources has increased dramatically, many of which have been successfully acquired through market transactions. A globalized market infrastructure has been established and no one country should be willing to pay the price of war to acquire resources.

Naturally, not everyone is in agreement with this assessment. Many believe that as resource shortages intensify, the competition over energy will eventually develop into war. The American occupation of Iraq is often cited as a decisive example supporting this line of thinking. However, the popular argument that the United States wishes to control and takeover Iraq’s oil resources for its own benefit is entirely out of touch with reality. In truth, the U.S.-Iraqi war is purely a conflict of ideology motivated by a sincere moral loathing of Saddam Hussein for being, from their perspective, a dictator. President George W. Bush has articulated the goal of annihilating all tyranny in the world. This drives closer to the heart of the current risk of war, at least between the United States and certain regimes. Wars of ideology have replaced wars over resources.

This is not to say disputes over possession of energy resources do not exist. The United States, Japan, Germany and all oil importing countries, including China, are competing for the use of oil. Yet there has been no threat of violent conflict as competition has thus far been resolved through market
mechanisms. Ideally, this will continue and there will be no war as long as the market governs the distribution of energy worldwide. Oil will be sold to whoever offers the higher price.

Exceptions to the Rule

Yet, a fundamental problem remains that not all resources in all regions have entered the market. A case in point is the East China Sea, where China and Japan struggle over the rights to exploit the sea’s gas fields. Will war break out as a result of competition over them? It cannot be ruled out entirely because there are other factors at play, including territorial jurisdiction, sovereignty and national pride. Concessions on territory, sovereignty and national dignity are difficult to make for any country (let alone for China and Japan, two nations with a difficult history). This is the stuff of politics, about which politicians and even ordinary citizens may find impossible to compromise. The problem is that while many bilateral issues do not originally involve elements of sovereignty or dignity, they are often introduced when politicians get involved, complicating negotiations.

However, it is unlikely that a conflict will break out between China and Japan over the oil and gas resources in the East China Sea. The reason is simple: resource development is profitable and these interests are more likely to hold sway in the end. Dividing the benefits between buyer and seller, between importer and exporter is a win-win situation. When negotiations fail, both sides suffer. If there is war, the cost will far outweigh any gain to a country and its commerce. Business people are universally pragmatic and will by no means turn a potentially profitable situation into a loss for both sides. Through mutual concessions a deal can always be reached without politicians calling for war.

Exporter Dependence

The market operates under its own rational principles. Buyers and sellers need each other; neither can exist without the other. This relationship is very firmly established within the law of supply and demand. It is usually observed that energy-dependent countries see oil as their lifeline and any supply disruption will immediately throw their economy into chaos. Yet, the other side of the supply-demand equation is all too often underestimated. Petrol states
are equally reliant on energy exports. Oil revenues are indispensable to their economies, providing a source of enormous foreign exchange to buy grain, medical equipment, vehicles, and accessories as well as salaries for civil servants. Oil is virtually their sole source of revenue and thus, whether they like it or not, they are guided, even decisively constrained, by the laws of economics. It is because the oil industry is a far easier economic endeavor than just about any other resource that many petrol states rush to exploit these resources and even become addicted to them. Unfortunately, the temptation is powerful for them to let their oil industry thrive while neglecting other sectors at their own peril. In the event that exports are interrupted, resource-based economies would likely collapse immediately.

This author once asked a professor of Fahd University in Saudi Arabia how long his country could sustain imports with its foreign exchange reserves if its oil trade was interrupted. His answer was a maximum of three months. Such states are arguably more fearful of being unable to export oil than energy-dependent states are of supply disruption. Without external influences, an equitable deal forged by both sides cannot conceivably encounter major obstacles. In this scenario, there is no possibility of oil-exporting countries using oil as a threat against oil-importing countries. Oil supply is therefore secure by any rational calculus.

**Politics Distort the Market**

This analysis is also evidenced in historical fact. The global political arena has always been marked by change and turbulence. Yet, whether one looks at periods of high geopolitical tension or intervals of cooperation, the energy market has never been discontinued. During the Cold War, the former Soviet Union exported natural gas to Europe virtually unimpeded, and following its dissolution, Russia continued to supply gas to Europe. Despite a change in leaders and one might say, regime ideology, Russia’s commercial energy contracts have never encountered any fundamental problems.

Given these facts, why is there so much sound and fury over oil supply security? The recent example of Russia attempting to halt the supply of natural gas to Ukraine is a case in point for analysis. First, the low cost supply of gas from the former Soviet Union to Ukraine was never based on a commercial exchange but rather a political deal. In 2005, Russia supplied Ukraine with gas at $50 per thousand cubic meters while it supplied gas to Western Europe at
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The root cause of all such disputes is that politics has penetrated the market. The natural gas contract between Russia and Western Europe is closer to a purely commercial contract. Each party needs the other based on unfettered economic principles. Without the involvement of politics, this relationship has remained surprisingly sound.

In a fair market, prices are consistent across the panoply of buyers and sellers. Fundamentally, it is not possible for a seller to sell at a higher price or a buyer to receive a lower one. To gauge whether a commodity’s price has been established through competition, one can simply check whether there is a unified price across the market. The value of foreign exchange, gold, oil and grain are all established by the international market each day. Price equilibrium is in turn an essential condition for optimum resource allocation. Take for example the current gap in oil and gas prices between countries. The price of Russia’s exported gas has up to a 500 percent difference between countries (this does not include the price of its domestic gas, which is even lower). This phenomenon is certainly not an outcome of market competition and makes such trade of gas very unreliable. Furthermore, oil prices within oil-export-
ing countries are significantly below market value. This has been extremely detrimental to the effective utilization of resources. When oil is scarce, as it is today, such huge waste deserves special attention.

The Rational System

In the past, when China exported its oil, international prices far exceeded domestic prices, and domestic and international markets were entirely segregated. Following the adoption of reform policies, China’s domestic crude oil prices began to merge with international levels, yet finished oil products continued to be controlled. Although world oil prices have gone up recently, China’s domestic price for finished oil products has remained low causing many domestic oil refineries to operate at a loss. As a result, smuggling of petroleum products has become rampant as domestic demand exceeds supply. Such price-setting policies are highly unfavorable for the rational allocation of resources and lead to significant waste.

To secure energy supplies, China is fostering good relations with many oil producers, including Russia, Kazakhstan, Nigeria and Venezuela. Meanwhile, it is also competing with high energy demand countries such as Japan and India. For instance, the proposed construction of a pipeline from Russia to Daqing in Northeastern China involved many ‘extra-market’ activities because of China’s competition with Japan. To secure oil supply from Africa, China often agrees to provide economic aid alongside energy contracts. Chinese leaders have increased their diplomatic visits to Africa, in part because of oil. However, the use of political influence to compete for oil supply is always dangerous as there are no permanent friends or enemies in politics. Using political alliances to seek secure oil supplies is a powerful tool but also very unwise. Consequently, the only reliable method to ensure China’s energy security and that of the rest of the world is to maintain political neutrality when reaching agreements through business negotiations on the basis of fair competition and market mechanisms.

The United States criticism of Russia for wielding oil and gas resources as a political tool is with good reason. Russia sells oil at prices often divorced from market levels, which is proof that oil is used as a means for political ends. The Organization of Petroleum Exporting Countries (OPEC), on the other hand, trade most of their oil at international market prices. During his
The recent visit to China, OPEC’s chairman clearly stated that the group’s goal as an economic organization is to make maximum profit. While this may sound harsh and calculating in an environment of high energy prices, it should come as a comforting and even a wise statement that dampens the negative psychological elements of tight demand and supply of the energy markets.

The commercial basis for oil supply is, above all, to privatize the energy industry, which will rationalize the transactions of oil resources on the market. China has sought far and wide to acquire secure oil supplies through oil equity on the international market. Yet, when it comes to China’s own domestic petroleum resources, there is little open trading as this sector is monopolized by state-owned enterprises (SOE). SOEs are often poorly managed and suffer from low efficiency and other deficiencies that are very difficult to correct. Therefore, privatization of the natural resources sector is the best path to rationalize the distribution of resources. If resources are traded and their ownership changes according to market rules, it will be possible to allocate them to those sectors that most need them. Privatizing energy resources will prevent politicians from using oil resources for purposes of political expediency, a phenomenon which increases the uncertainty of supply. Private businesses are thus directly faced with higher and more varied risk that can even lead to bankruptcy. Nevertheless, they are best suited to avoid such risks through increasing efficiency, restructing and optimizing allocation of resources. This is not only economically rational but also increases the supply of resources.

Having been educated under a system that puts the state in a superior position, ordinary people in China will have great difficulty in accepting these changes quickly. Even the United States, where resources are owned privately, has had doubts when it comes to mergers and acquisitions of international energy companies. Governments impulsively seek to maintain ownership over key resources because they believe that doing so provides a greater measure of control over national security and the state can thus better serve the public interest. There is often the belief that in privatizing development of such resources, the public interest itself would be privatized and national security jeopardized. However, there is little evidence to support this notion. It must

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be realized that the sole purpose of natural resources are their means as a tool to serve the economy, and it is the market that can most efficiently distribute such resources. Political control, on the contrary, invariably distorts the allocation of resources because its possession of them is often connected to the personal gains of politicians, or as a means to achieve power. As for the concerns about profiteering by private entities, this can be fully corrected by vigilant and robust tax regimes.

A Place for Politics

So what role do politics and policies have in securing a reliable energy supply? They can protect market mechanisms, foster global economic integration and implement the World Trade Organization's free trade rules without exception, and regulate all trading practices to comply with the principle of open market exchange. Unlike safeguarding a territory, which has clearly defined borders, protecting the market is about defending a series of intangible economic rules. Put simply, prices rise when supply is short and they fall when there is an oversupply; buyers look for sellers who offer the lowest prices; and sellers look for buyers who offer the highest purchase price. These market forces are impersonal. Buying and selling is based on price, not on any extraneous characteristic of the buyer or seller. Frankly, it is economically impossible for oil to not be purchased. One may not want to acquire a resource because the price is not high enough to make a profit. The corollary is that it is impossible for oil not to be sellable; it is only possible that the price is not low enough.

In light of this, China and Japan do not have to compete for Russia's natural gas. Even from the perspective of supply security, the result is the same regardless of who acquires it. If Japan prevails, it will no longer need to purchase natural gas elsewhere and China can take up the slack somewhere else in the market. Similarly, if China buys Russian natural gas, it will not pose a threat to Japan's ability to acquire that energy source elsewhere.

However, while market-oriented commodity trading can ensure supply security, it cannot ensure price stability. Prices change as the supply and demand situation changes. This is quite necessary. If prices remained unchanged and the scarcity of resources was not reflected in price, the world would fall into chaos. This is the most fundamental tenet of economics.
A Threat to the Market Overcome

As mentioned above, with the impetus of global economic integration, it is highly unlikely that there be wars over resources in the future, though a few possible exceptions exist. Such exceptions are most likely to occur when a weak, resource-rich country confronts a powerful country, in which the latter may not hesitate to start a war to seize the resources of the former, even if there are no political motives such as territorial expansion or hegemony. From the cost-benefit perspective alone, such a possibility exists.

One recent example is the first Gulf War when Saddam Hussein invaded Kuwait. The purpose of the war was, chiefly, to obtain oil. The cost of the war was low because Kuwait was small and militarily weak. Had no one intervened to halt this invasion, it would have become a global disaster, as it would have destroyed the fundamental market principle of price as the principle arbiter of supply and demand rather than force. This instance demonstrated that military might could be employed to secure resources thus altering the rules of resource allocation. As it happened, Saddam’s brazen aggression was arrested by the United Nations. The United States deployed its army to drive the Iraqi army back. Saddam’s error brought disaster on the Iraqi people and Saddam himself and even today, the country has not recovered from its predicament. On the other hand, the rules of an open market system have been further fortified and a similar event is unlikely to occur in the future.

China’s Role

Until recently, China has been an economically weak country. Its share of the world market was very small and China was essentially a bystander of the global system. Now, however, the situation is significantly different. In 2004, the world’s crude oil trading volume totaled 1.85 billion tons, with China accounting for 6.5 percent of it. The United States accounted for 27 percent and Japan 11.2 percent. In the iron ore and timber markets, China’s share of global trading was even higher. China is rapidly transforming from an onlooker into a full-fledged participant. Such a change naturally grants China both more rights and more responsibilities in sustaining the world market. In the past, such rights and duties were undertaken by the countries with the biggest market shares, particularly the United States. China often sought to challenge this status quo. No more. China has a deep stake in protecting the global order, though its role as a key player has yet to be fully realized.
The global oil markets, particularly in the Middle East, along with their transportation routes, urgently need protection. At present, the United States assumes this role of guarantor almost exclusively. Undoubtedly, the U.S. deployment of aircraft carriers to safeguard the sea lanes of communication has greatly benefited Japan, Taiwan, New Zealand, as well as the Chinese mainland and India. But the political issues in the Middle East are fiendishly complex and cannot be undertaken by any one country alone. China has an important role to play by helping them achieve economic stability and improving people’s lives. This is particularly true in Iraq, where the United States is in a crucial dilemma. If China helps build power plants, highways, ports, and transportation pipelines in a cooperative manner, not only will Chinese businesses possibly profit from the construction contracts, but it will bring social stability as well as increased oil production and exports. The United States should not oppose such acts, and would probably be grateful. Others in the region have problematic relations with the United States, while China enjoys greater acceptance by various governments. Why shouldn’t China take full advantage of this by providing economic assistance to these countries? All of these issues are deeply integrated with oil security, and China should fully participate.

So, what is the most important task facing political leaders all over the world? It is to protect and sustain the global market. For without it, there will be no alternative to allocating global resources other than going to war.