



The Roving Scout



ADITYA BIRLA GROUP

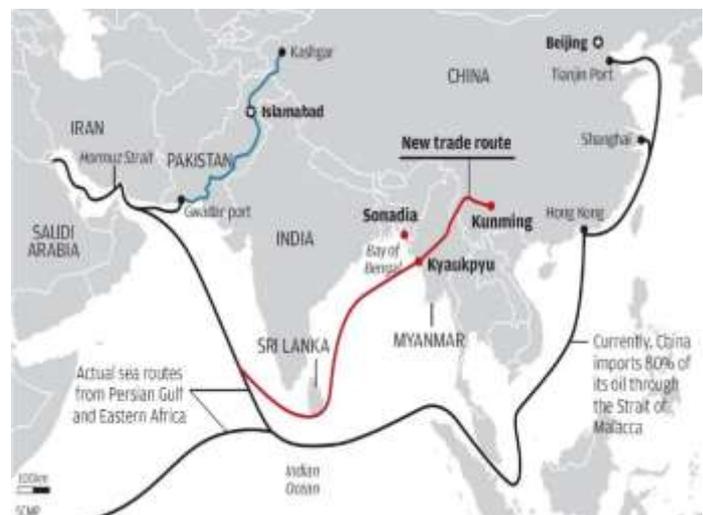
SOUTH CHINA SE(E)A

China's aggression behind South China Sea dispute was openly visible after it rejected the verdict from the International Tribunal in The Hague that backed the Philippines case on the disputed waters. Apart from China and Philippines many other countries namely Vietnam, Taiwan, Malaysia and Brunei have wrangled and have competing claims over the disputed territory. Tensions in the South China Sea have grown in recent years as China has built artificial islands on reefs and atolls it occupies, triggering alarm from smaller neighbours and prompting the U.S. to send warships under the pretext of freedom of navigation. It is estimated that annually around \$5.3 trillion worth of goods pass through the South China Sea of which US' accounts for \$1.2 trillion. Oil transported through the Malacca Strait from the Indian Ocean, en route to East Asia via the South China Sea, is triple the amount that passes through the Suez Canal and fifteen times the volume that transits the Panama Canal. Around 2/3rd of S. Korea's energy supplies; ~60% of Japan's and nearly 80% of China's crude oil import pass through South China Sea.

Given the strategic importance of South China Sea as international trade route, why would China challenge its neighbouring countries – who are also allies to US – and threaten to disturb peace in that region. One obvious reason is massive potential for Oil and Gas reserves in that region. It is estimated that South China Sea holds ~11 billion barrels of oil and 190 trillion cubic feet of natural gas - enough to meet twenty-eight years of China's N.Gas demand. But can **China still afford to 'de-stabilize' its own trade route apart** from the advantage of holding potential high natural resources the region embraces. Answer to this is partially **'YES'** it has potential to de-stabilize the peace in South China Sea by cornering the region. To understand why and how China could possibly do so one needs to understand the **"CPEC Agreement"** (China–Pakistan Economic Corridor).

China–Pakistan Economic Corridor:

Often referred to as CPEC, is collection of projects currently under construction at a cost of \$46 billion – aimed to upgrade the Pakistan's infrastructure as well as to deepen the economic ties between Pakistan and China. CPEC is considered to be an extension of China's ambitious One Belt, One Road initiative. A corridor of highways, railways and energy pipelines that will run from Kashgar in China to Gwadar in Pakistan (Baluchistan) on the Arabian Sea near Iran border i.e. from north to south of Pakistan. All of Gwadar, include a mega international airport, hospitals, schools, colleges, tech institutes and even a Metro line in Lahore.



Believe it or not the most important highlight of this corridor is all the infrastructure and associated projects under CPEC will be constructed for Pakistan by China, free or for negligible loans. Approximately \$11 billion worth of infrastructure projects being developed by the Pakistan government will be financed by concessionary loans, with composite interest rates of 1.6%, almost reduced to half after Pakistan successfully pushed the Chinese government to reduce interest rates from an initial 3%. The loans are subsidised by the Govt. of China, and are to be dispersed by the Exim Bank of China and the China Development Bank. For comparison, loans for previous Pakistan's infrastructure projects financed by the World Bank carried an interest rate between 5% and 8.5%, while interest rates on market loans stood at 12%.

This explains why China continues to support Pakistan in thick and thin given the billions of dollars at stake. China which is going out of way to develop Pakistan's infrastructure now technically owns 20% of Pakistan's GDP. The infrastructure development move by China is not just to deepen the economic ties with Pakistan but to use its infrastructure (rail, road and pipelines) **to ferry oil and gas** and other commodities from Baluchistan port Gwadar to Kashgar in Xinjiang through Pakistan occupied Kashmir (PoK). And this is where it matters most for India to oppose the CPEC agreement. The karakoram highway (four to six lanes) passes through Gilgit Baltistan area of Jammu and Kashmir State, which belongs to India, but illegally occupied by Pakistan. Pakistan and China are connected through PoK and success of CPEC would depend on karakoram highway – and this is why Pakistan (indirectly China) wants to keep the Kashmir issue burning and continue to occupy the region illegally. If India were to get back PoK it would squeeze the Karakoram Highway and shut it down. Result no more CPEC, Silk Road. That is the whole game. Whoever controls the highway controls the region. But we shall wait for time to decide what is written in India's destiny...

The CPEC agreement is perfect win-win situation for both China and Pakistan. China has strategically supported Pakistan despite of reluctance from global economies amid extremism being carried out by Pakistan against its neighbouring countries. This is perfect opportunity for China to flood Pakistan and Gulf with its cheap products and make billions there. Once Gwadar port is operational it will reduce the travel distance for China to less than 5000 km from 16,000 km currently thereby diversifying its energy trade routes to and from the Middle East via Pakistan. The new Oil trade route shall save millions on transportation cost and Gwadar ports proximity to Africa (only 12 hours by sea) further ads armoury to its trade dominance across globe. Even if USA tries to choke Strait of Malacca via Singapore and Indian Ocean via India, China will have no problem in continuing to increase its presence in the disputed region given its new trade route (Blue line in above diagram). At present, Gwadar is being developed as a commercial port and not as a facility for the Chinese Navy—yet it could potentially be made into one in the future. This would help China to increase its military presence in Arabian Sea thereby protecting its maritime rights and interests in the region.

To Conclude:

Will China Escalate the South China Sea Issue: While there is huge potential for China to increase the tensions in South China Sea by cornering the region, we believe escalation won't take place at least till 2020-21. Reason being though China is developing new energy trade route (Gwadar to Kashgar) China still needs to continue importing Coal via South China Sea as the new energy trade route is uneconomical when it comes to importing dry bulk in terms of freight rate. Which means China effectively will not escalate the issue till it becomes self-sufficient in terms of coal requirement. China has 27 nuclear power reactors in operation and 24 more are under construction with advanced technology. By 2020-21, the nuclear capacity is expected to be increase three-fold. The impetus for increasing nuclear power share in China's energy mix is due to air pollution from coal-fired plants. This should decline the demand for Coal substantially and reduce the import demand for thermal coal used for power generation. While the escalation largely depends on success of CPEC which in turn also depends on India's stance on PoK and future of Baluchistan's freedom movement as most of CPEC infra passes through Baluchistan.

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