China’s petro & MENA’s yuan

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- In the long term, China will remain dependent on crude imports. For national security reasons, China has sought to diversify its energy portfolio across geographical regions.
- Crude imports from Iraq, Oman and Russia have surged relative to those from Saudi Arabia and Iran. China’s use of loan-for-oil deals has strengthened its hand vis-à-vis OPEC producers.
- China has started paying in renminbi (RMB) for crude imports from two of its key suppliers, Russia and Iran. But it will take time before the petroyuan is accepted by the entire MENA region.

China’s energy quest will continue

China is growing dependent on oil, and is projected to import 8M bpd by 2020 and 11.4M bpd by 2030, compared to 7.6M bpd in May 2016 (Figure 1).1

- Since 2000, China’s oil import dependency almost doubled, from 30% to 57%.
  - China’s reliance on imported crude will continue to grow. Since 2013, China has become the world’s largest net oil importer, overtaking the US by as much as 1M bpd in 2014.
  - Since China imports over 50% of its crude from OPEC, its oil dependence is enough to become a cause for concern on national security grounds.

Diversification within & beyond MENA

To manage its oil dependence, China has already been diversifying the sources of its crude imports from both within and beyond the MENA region.

- In October 2015, OPEC’s share of Chinese oil imports stood at 55%, down from 68% in mid-2012, with Saudi Arabia’s share falling from 20% to 16% and Iran’s from 9% to 6% respectively.2
- The relative decline is partly checked by the rise in imports from Iraq and Oman, which accounted for 10% and 12% of China’s imported oil in October 2015, respectively.
  - China is already the largest foreign investor in the Iraqi oil industry, holding substantial stakes in an oil field in Kurdistan and in al-Ahdab, Rumayla, Hafayla and West Qurna 1 in the south.
  - In a move to further secure energy supply, China is also actively expanding Port Tripoli, Lebanon, as well as Port Said, Egypt. Port Tripoli is on the receiving end of the Mosul-Haifa oil pipeline (now-defunct), whereas Port Said hosts the Damietta-Port Said gas pipeline (operational).

- In South Sudan, Beijing has also committed diplomatic capital, including over 700 Chinese troops as UN peacekeepers, to mediate the country’s civil war, and protect the country’s 120K bpd of crude supplies.
- China’s growing interests in MENA will result in a gradual expansion of its political involvement there, but not in ways that constitute major departures from its non-interference policies, which have been the cornerstone of Chinese foreign policy.

- Another noteworthy development is the dramatic rise in Russia’s market share vis-à-vis Saudi Arabia and Iran. China’s Russian oil imports grew 3% YoY to about 810K bpd in the first nine months of 2015.
- Loan-for-oil deals are a key driver of the oil trade growth between China and non-MENA producers. From 2009, China’s loan-for-oil deals with Russia, Angola, Venezuela and other producers amounted to USD 45B, contributing to 30M tonnes of crude reaching China annually.
- As the oil price remains sluggish, loan-recipient countries are required to export more crude to China in order to repay the given amounts of loans.
- Nonetheless, MENA oil producers can take comfort in the fact that Chinese enthusiasm for loan-for-oil deals has been somewhat dented, as credit risks loom large for its loans to Venezuela and Angola.

- China is steadily making progress in accumulating Strategic Petroleum Reserves (SPR), at a rate of 1.2M bpd in Jan-Jun 2016, up from 491K bpd in Jan-Jun 2015.3
- By August 2016, China’s SPR is expected to reach its current capacity limit of 511M barrels, enough for it to supply over 70 days of imports.
- China’s SPR boasted 400M barrels in total in June 2016, still 200M barrels short of its 2020 target.

- While Chinese diversification will remain a potent force in the oil market, we expect the Middle East to remain China’s top choice in the short-to-medium term at a time when the pie of Chinese demand is growing. In May 2016, Saudi Arabia, Iran and Iraq’s crude exports to China soared by 33.6%, 19.5% and 56.6% YoY respectively, albeit against Russia’s 52.4%.
- One major factor is that Beijing has been actively substituting coal with oil and gas as part of its environmentally friendly drive to cap coal use to 62% of total energy consumption by 2020 (Figure 2).

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1 EIA.
2 China’s General Administration of Customs.
3 JP Morgan.
- In addition, Chinese refineries' preferences for the GCC’s medium-to-heavy grade to which their production lines are catered will mean China’s demand for Saudi oil will remain inelastic for some time to come.
- More broadly, Chinese diversification will not imply its absence in the Middle East and Africa. Combined, the two regions are home to half of Chinese companies’ overseas oil production, a showcase of the country’s continued interest in oil trades with these regions.

Crude to China, yuan to MENA

Now being the world’s largest trading nation and net importer of crude oil, China would also naturally desire to make at least part of its oil payments in RMB.

- Beijing hopes that the rise of the petroyuan will provide a stable anchor to the value of the RMB, thereby establishing the RMB as a global reserve currency.
- China already has been paying part of its purchase of Iranian oil in RMB as early as 2012, as Iran sought to get around Western financial sanctions.
- In 2015, Qatar became MENA’s first hub for clearing transactions in RMB, following a USD 5.78 currency swap with the People’s Bank of China in 2014 (Figure 3).
  - Concurrently, China and the UAE renewed their currency swap agreement in December 2015, leading to a swap line totalling USD 5.2B.
  - The petroyuan would not be aided by Qatar and UAE, however, as evidence suggests, RMB clearing is likely to first start with non-oil trades.
- In the wake of Western sanctions, Russia has also accepted selling oil to China in RMB.
  - While sanctions only target individuals and businesses, Russian officials are vigilant to the risk that they could one day be shut out of the dollar-based international financial system.
  - Gazprom Neft, Russia’s third-largest oil producer, has reached the stage of selling all of its China-bound crude in RMB from mid-2015, whereas Rosneft, the largest producer, has received RMB credit from Russian state banks.
  - Russian embrace of the RMB largely contributed to its capture of Chinese oil market share at the expense of Saudi Arabia, for the second time, in the first five months of 2016. However, Saudi Arabia retook the top spot in June, as they intensified price competition and, for the first time, sold a spot crude cargo of 730K barrels to an independent Chinese refiner.
  - The fight for market shares on the currency front will continue, although Russia would not wholeheartedly underwrite the rise of the petroyuan should Western sanctions be relaxed.

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4 EIA.
6 S&P Global.
1 Arabia Monitor; People’s Bank of China.
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