A CHANGING CHINA:
THE RESOURCE CHALLENGE

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Introduction

This past weekend in Beijing, the airport highway has had one northbound and one southbound lane closed to regular use. Vehicles registered in neighbouring provinces were forbidden to enter the capital. Half of the cities workers were give two extra days off to decrease pressure on the inner city’s roads and services. And right across the sprawling capital city, bright red and yellow bunting crackled in the early November northerly wind, portraying everywhere the slogan, written in Chinese, English and French, “Peace, Friendship and Cooperation in Development”.

Africa has been in Beijing this past week. Some forty-eight heads of state or heads of government had accepted the Chinese invitation to the first China-Africa Summit. Forty-eight countries whose governments were being wooed by a China that forty years ago exported little more than arms for anti-government guerrillas and revolutionary rhetoric. Now China has become vital as a market for African resources and as a source of capital for African development. Forty-eight governments travelled to Beijing to pay homage at the throne of the Middle Kingdom.

Africa is of course not alone. A week earlier all of the ASEAN heads of government gathered in Nanning with the Chinese Premier, who arrived late because he had been receiving Jacques Chirac of France. There is probably no busier capital city in the world today than Beijing, as leaders from around the world descend to court Chinese investment and seek access to Chinese markets. Imperial China redux.

The emergence of China as a major economic power, especially when coupled with growth elsewhere in Asia and in India and Brazil, may well be turning this century into the century where human activity truly starts to stress global capacities to provide the resources to support that activity. The Club of Rome’s alarmist predictions of the mid-1970s may prove to have wrong in timing but correct in direction.

And we have only just begun to confront this shifting resource challenge, because the underlying forces behind China’s growth are only just revving up. The trends that are driving economic and social change in China today are likely over the next quarter century to sustain a growth rate that, while not necessarily smooth, will likely remain substantially above global averages. The challenge that China faces in meeting its resource needs will affect not only the pattern of its own growth, but global resource markets, technological innovation and international politics. How other countries respond to a China increasingly dependent on imported resources may well be one of the most important determinants of whether or not China remains on a course convergent with western democracies. These trends and issues have profound and long-term implications for the Canadian and international business community and should not be ignored in current corporate strategic planning.
Chinese Economic Growth and its Drivers

China seems to be able to outpace all the forecasters. For years on end, banks and investment firms and the Economist have all had to repeatedly upgrade their growth forecasts for China’s consumption of mobile phones and cars and copper and cement. Predictions of hard landings and slumps and coming collapses have been blown away by sustained national growth rates that have seemed unaffected by internal political disarray, regional financial crises, global stock-market collapses and, more recently by national efforts to cool the economy through fiscal and monetary measures. In late 2005, we read the extraordinary news that China’s National Statistical Bureau was revising its estimate of the size of the national Chinese economy upwards by a quarter of a trillion dollars. Somehow, the statisticians had misplaced an Argentinia or one and a half Albertas.

And the growth continually outpaces projections. This year is another case in point. Deutsche Bank and JP Morgan have recently upgraded their forecasts to about nine and a half percent growth for 2006. The World Bank has been calling for nine percent. But the government’s own Development and Reform Commission is quietly admitting what some of us in the marketplace have been saying since the beginning of the year; nothing short of a catastrophic event like a global pandemic will bring 2006 growth to under ten and a half percent.

This is not a recent phenomenon. For the past five years, the country has outpaced even the most experienced economists’ expectations. This is partly because none of us, not seasoned China watchers, not little computer guys who run models in the basement of the IMF, and not even China’s own national economic planners, have ever experienced economic change as broad and as deep as China’s today. We are witnessing an unleashing of suppressed appetites and desires never before seen in our lifetimes, and a simultaneous unleashing of the entrepreneurial energy of a populous, industrious and determined people.

The Chinese have been hungry for things they have not had for as long as they have been aware of those things, not simply for the half century since the foundation of the People’s Republic but since the beginning of reform and modernization at the turn of the last century when they threw off the shackles of dynastic rule and foreign domination. They now plan on catching up quickly.

Economic growth of just under 10% per year has been remarkably consistent since 1978, when Deng Xiaoping, stating in a famous speech that “It doesn’t matter whether a cat is white or a cat is black, as long as it catches mice”, set aside decades of ideological lurching in favour of pragmatic gradualism. True, growth ran away to 14% for a year or two, and dipped deeply but briefly after the Tiananmen crisis of 1989, but on average has been consistently treble that of an OECD and a world in general that have averaged around 3%. That is a lot of catch-up in a quarter century, and it has brought the aggregate size of the Chinese economy to the status of fourth largest in the world measured traditionally and second by purchasing power parity, but in fact it is just the beginning of the story.
In spite of the huge penetration of Chinese products into global markets, the key drivers of the Chinese economy today are fundamentally domestic. Although domestic consumption has not yet outpaced investment at an aggregate level, its rate of growth has been such that its contribution to national GDP is now much larger than net exports.

Domestic demand is now substantially more important to national growth than exports and is being driven forward by what I like to characterize as two “national transformations”. The first of these is the transformation of China from a rural and largely agrarian society into an urban society. At the end of the Cultural Revolution in 1978, some 17 cities had populations of more than four million, and more than 80% of Chinese still lived on the land. Over the last twenty-eight years, the urban population has swelled by some 400 million people, and now some 50 cities have populations in excess of four million.

And urbanization as a process will continue for a long time to come. Driven by a push to improve agricultural productivity and agricultural incomes by having fewer numbers of people producing the same or larger amounts of agricultural produce, and pulled by the offer of low-skilled employment in the towns and cities, some 20 or 25 million people move from rural settings to urban settings every year. This means more roads and bridges and buildings and electrical consumption. This in turn is being fed by vast inputs of steel, zinc, nickel, and copper, vast mountains of cement (in each of the last three years, China has represented more than 50 percent of the global consumption of cement), and more energy and oil. And as another four or five hundred million more people move into the cities over then next twenty years or so (leaving China still with a proportionately much larger rural population than Japan, North America or Europe), this will mean a constant draw on national and global resources.

The second “national transformation” underway is the shift from a subsistence economy into a consuming society and the emergence of a large dynamic and middle class. At the end of the Cultural Revolution in the late 1970s, there was simply no discretionary spending in China; there were neither the goods to buy nor the capacity to buy them. Gradually over the last twenty years, a real middle class has emerged, numbering today perhaps around 125 or 150 million strong (depending on one’s definition, but it would be in this neighbourhood if it were defined as discretionary spending in excess of 20% of annual income). This middle class is growing by roughly the same pace as urban China, or 20 to 25 million people a year.

The single most important impact of the emergence of the Chinese middle class is on housing and construction, as people seek to buy homes for the first time or to move to better or bigger homes. Housing reform in the mid-1990s transferred state-owned housing to its inhabitants in perhaps the largest asset transfer in history, giving Chinese home-owners assets both tangible and leveragable. It also unleashed a vast demand for better housing and a construction boom that continues across China today. And still the Chinese are under-housed relative to their Asian neighbours, and relative to the national standards for housing size (at an average of less than 20m² per capita compared to the national objective of 30 m² per capita).

A further driver of aggregate consumption is the infusion of credit into the society. Although mortgage lending is now common, auto-financing being rolled out along
with the rapid growth in private car ownership, and credit cards beginning to appear (still a tiny percentage of debit cards), the Chinese consumer is substantially under-levered relative to consumers in more developed economies. This will change and as it does, moving from a cash economy to a credit society will mean a little extra boost to consumption (or a little shock absorber against downturns), and therefore to national growth, every year until aggregate credit levels stabilize at what will be sustainable in the Chinese context (probably not as high as North America, but even Japanese levels are substantially higher than Chinese).

Patterns of growing Chinese consumption go well beyond housing and cars and the credit that fuels their purchase, as important as these are for any economy. Chinese are emerging as substantial spenders on consumer goods of all sorts, from electronics to fashion to travel and leisure. And, irrespective of our Canadian fondness for open space and a sparsely populated land, numbers count. By 2020, China is expected to have as many consumers as the United States and the European Union combined.

Chinese demand for energy and minerals, and the capacity of the world to meet that demand, become defining issues for the global economy.

**The Shift from Protected to Exposed in Resources**

When Deng Xiaoping launched China’s great pragmatic revolution at the end of the 1970s, the country could still hew closely to Mao’s tenet of self-sufficiency. It had great reserves of coal, supplied all its own needs for every base metal, and could meet its own oil needs. In fact, in the global commodity markets, the only relevance of China was in grains and agricultural inputs. This was great for Canadian wheat farmers and potash miners, who took an interest in the Chinese harvest, but for metal traders and for the oil patch, China did not matter much.

No longer. By the middle of the 1990s the situation began to change radically, as the expansion of Chinese domestic supplies of most minerals and of oil and gas was overtaken by the growth in demand. And in one commodity after another, China slipped into deficit. In 1996, China became a net crude oil importer. Today the Chinese economy has passed from largely protected from global demand and supply balances and pricing to completely exposed. Today, China has become the world’s largest importer of iron ore to feed a steel industry that produces more steel than the United States and Japan combined. It imports more copper and more alumina than any other country, consumes more nickel than Japan and will probably outstrip it in imports this year. (Unlike Japan, China has substantial nickel resources of its own although not enough to meet demand.) China has even become an importer of metallurgical coal and of zinc, two commodities which traders just a few years ago believed would forever be staple Chinese exports.

The imbalance will over time only get worse. In spite of new oil fields being found in western Heilongjiang and in the South China Sea, the rate of depletion in the fields of Daqing and other producing regions means that new finds are likely only to reduce the rate by which imports grow. Even if China can sustain domestic production levels more or less at current levels for the next twenty-five years (which
most observers including myself believe is not likely), China will be importing a full fifty percent of its oil needs by 2020 and close to 80% of its needs by 2030.

The story is the same for copper and nickel and bauxite. I do not wish to provide a litany of statistics on supply and demand imbalances in each of the major base metals and other key commodities. Suffice it to say that the country cannot rely on domestic inputs to build all the homes and factories, highways and towers, shopping malls, athletic stadiums and subway systems that will be built over the next half century, much less to produce the cars and computers, sofas and tables, shirts and socks and shoes and MP3 players that its factories will churn out in ever larger quantities to meet growing domestic demand even if export markets stabilize.

It was really only at the beginning of this new century that China’s political and industrial leaders began to take account of the fact that China was entering a new stage in its existence because of this resource imbalance, a new vulnerability in their eyes. This realization has fundamentally changed the way they see the world and how they behave on the global stage.

**China’s Foreign Policy as Resource Policy**

When I was in the Canadian foreign service, I was a vocal opponent of the endless efforts to re-define Canadian foreign policy by some new government or another, each looking for special catchwords of the day or flavour of the moment, and each trying to deal with the discomfort of a naturally close relationship with a major and largely friendly power to the south and a somewhat ephemeral Canadian influence on the international stage. A former colleague of mine used to quip that our foreign policy was simply to “sell Canadian wheat and prevent nuclear war”. In fact, any country’s foreign policy can and should be nothing more than the protection and promotion of its own national interests and those of its people.

In the early decades of the People’s Republic, Chinese foreign policy was as dominated by ideology as was its economic policy, and the results were equally dismal. Supporting revolutionary movements in far-flung countries may have sustained civil wars but did not produce sustainable allies. And ideological vitriol hurled at western powers may have produced catchy quotations and some near-great revolutionary songs, but it enhanced Chinese security not one whit. Just as Deng Xiaoping set aside ideological adventurism in economic policy when he returned to power, so did he establish national economic interest as a fundamental principle for Chinese foreign policy.

It should thus come as no surprise that, once China’s growing and long-term vulnerability to the international supply of oil and other mineral resources became evident to the Chinese leadership, as it did early in this decade, that we would see an immediate impact on Chinese behaviour on the world stage.

President Hu Jintao’s trips over the last two years to Venezuela, Algeria and Egypt and his courting of the 22-member Arab League in Cairo a year or so ago were all about oil. The almost completed Free Trade Agreement between China and Australia is about access to its resources, from LNG to iron ore to uranium. And the
courting of Brazil, with whom China has exchanged three times as many Ministerial visits as with Canada over the past two years, is all about iron ore.

It is neither random nor surprising that Chinese state-owned firms are buying steel assets in Brazil, oil and gas resources in Indonesia, Australia, Peru, Ecuador, Chad and Kazakhstan, zinc in Mongolia, copper in Guinea and bauxite in Vietnam. Investments in nickel mines in the Philippines and Papua New Guinea have been the single most significant announcements made during state visits to those countries, while virtually every deposit of every known mineral in the immediate neighbours of Vietnam, Laos, Cambodia, Myanmar, Kazakhstan and Mongolia has been visited by delegations of potential Chinese buyers from Minmetals, China Non Ferrous, Jiangxi Copper, Jinchuan Metals or some other large Chinese mineral company.

The China-Africa Summit, held these last few days in Beijing, and the posters of “Peace, Friendship and Development through Cooperation” are the embodiment of Chinese foreign policy today, which is first and foremost about resource security. China has invested in the Congo and in Madagascar and elsewhere and is demonstrably ready to pay for infrastructure and development projects to ensure the security of resource supply from its African partners.

It also should be no surprise that China, in its quest for resources, crosses the bows of American foreign policy. For China, getting five percent of its oil from the Sudan is an important component of keeping its sources of oil diversified. Its relations with Teheran require a careful nurturing due to the significant oil supplies it obtains from Iran and the promise of substantial LNG flows in the future.

China’s foreign policy is not about countering the United States, however. It is simply about getting access to resources and ensuring that its security of access is assured through a diversification of sources. China knows that it does not have the military heft to challenge the US or to protect its supply of resources from a country far distant. So it instead seeks to maximize its sources of supply. This includes seeking resources from inside the developed world. A very senior Chinese official told me a little more than two years ago that North America was seen as the preferred region of the world for resource investments – but only if it could get access to significant resources there.

The Politics of Resource Acquisitions

Sinopec invested here in the Northern Lights project in the summer of 2005 precisely because Canada was viewed an open economy in which an investment would be welcome and secure. This is also why CNOOC invested in MEG Energy just a few months earlier. But such investments have been relatively small in both size and number, and it is important to recognize that what has not happened is far more significant than what has happened. It is not a well-kept secret that other Chinese players looking to spend very large amounts of money here in the oil-sands in joint venture with Canadian players have been largely rebuffed. Even if the reasons for turning the Chinese away have been a mix of a lack of need for Chinese capital and a perception that the Chinese are difficult partners with which to come to definitive terms and have not been anti-Chinese, the reaction in China to these
rebuffs has been to turn increasingly to oil supply arrangements from countries the United States treats as pariahs.

The failed CNOOC attempt to take over Unocal in 2005 left serious scars. Although nobody could make a credible case for there being a Chinese threat from the purchase of the US company, especially as it was CNOOC’s express intent to put up for subsequent sale Unocal’s assets in the Gulf of Mexico, China’s poor international image among the American public did it no favours. A well-oiled counter attack by Chevron (the competitor that eventually bought Unocal), and US politicians eager to affirm their patriotism through passing a congressional resolution declaring that such a purchase would threaten American national security easily sank the deal.

A similar albeit somewhat less vehement reaction erupted in Canada, also in 2005, when China’s large metals trader, Minmetals, launched a bid to buy Noranda. Originally intended to simply buy the Brascan minority interest in the company, the bid expanded to include the entire company when it became clear that this was necessary to obtain the support of Noranda itself. Although the bid eventually failed for reasons (and I discuss these reasons below) other than any measure taken by Investment Canada or the political level in Canada, there were plenty of editorials and public commentary to demonstrate a widespread aversion to a Chinese company taking over a Canadian one, even if most of the company’s productive assets were outside of Canada. You can imagine the reaction of influential people in China, having seen this aversion to Chinese ownership, now that Switzerland’s Xtrata has bought Falconbridge and Brazil’s CVRD has bought Inco. Foreign ownership seems welcome, as long as it is not Chinese.

As we in western countries demonstrate our reluctance to accept Chinese investments here, we put at risk a number of our own objectives.

First, to the extent that we deny Chinese access to resources in our own countries or in countries which the United States might view as its own backyard or traditional territory, we encourage China to cozy up to, and through large investment projects, support, regimes whose interests are antithetical to ours. This can undermine American and more generally western foreign policy, but we should not be surprised that the priority of resource security and the diversification of supply will trump every time any desire to cooperate with America in dealing with the challenges posed by such events as the civil war in Sudan or anti-American policies in Venezuela or Bolivia.

To discourage Chinese investment in resource projects in our countries and in countries where we want to invest, and then to challenge their right to invest in the countries in which we, for global political or human rights reasons, do not want to invest invites confrontation and substantial friction. This bolsters cries inside China for a foreign policy less cooperative with the United States and the west and for greater military reach and more robust spending on naval and other power projection forces.

Second, we should also recognize that appearing hostile to Chinese investments is likely to result in a Chinese hostility to foreign (meaning our) investment in China. Already, a few high profile companies may be caught in a revenge rebuff. The US private equity firm Carlyle Group is finding stalled its bid to take over Xugang, a leading and very large (US $2 billion in annual sales) Chinese manufacturer of
construction equipment. Government officials at the highest level have been public in their pondering of the question of whether or not the company is “strategic” and should therefore be kept in Chinese hands.

Recently, a think-tank under the powerful National Development and Reform Commission published a study calling for the creation of a government body to “rigorously examine” foreign takeovers of state-owned companies. In August of this year the Ministry of Commerce, jointly with five other national regulators, issued new tighter regulations governing foreign mergers and acquisitions with and of Chinese companies.

In fact we have seen over the last year a greater public debate in China about the long-term risks of having too open an investment regime. In the minerals sector, it is salient to keep in mind that Canadian mining firms are in the forefront of trying to pry open China’s investment rules as they relate to foreign ownership of high grade deposits of gold and to the security of ownership of mining rights to deposits discovered by foreign explorers irrespective of their size or strategic importance.

Public reaction to potential Chinese takeovers has not, of course, been the only reason that some of the more high-profile acquisitions have failed. In the case of the failed Minmetals bid for Noranda, and in two other cases which have not become public but in which my firm was involved as financial advisor, the ultimate cause of failure was an incompatibility of the Chinese approval system with the dynamics of western public markets.

In simple terms, for a Chinese state-owned company to proceed with an overseas purchase it is necessary to obtain not only the funding necessary to make the acquisition, but also the approval of the National Development and Reform Commission, and for the purchase of any significant asset (in excess of $1 billion), the State Council. As it is not possible to obtain approval unless the precise deal terms have been struck, and as the approval process cannot be completed in less than two or three months, few public companies are in a position to guarantee terms that remain unchanged for such a long period of time. And Chinese buyers, frustrated by their own system, have been unable to obtain advance permission to proceed with a purchase as long as it might fall within a set of prescribed price parameters.

In one case involving a mining asset here in Canada, a third party came in with an immediate cash offer at a higher bid just as the Chinese company was approaching the NDRC for a deal for which the terms had been agreed. In another, involving a minority investment in a mine in a third country, a Chinese interest was thwarted by a much faster moving Korean consortium that needed no government approval at all.

My final note on Chinese acquisitions of substantial resource assets in countries like Canada or the United States would be that Chinese firms, perhaps for understandable historical reasons, have not to date demonstrated a mastery of public diplomacy, and they have frequently not been helped by their government either. Ensuring public support for a proposed acquisition or merger is, or at least should be, a vital part of the strategy of any sensible company (as John Cleghorn of the Royal Bank and Matt Barrett of the Bank of Montreal learned in their failure to win the public campaign for their proposed bank merger in the 1990s).
Chinese firms have been slow to engage in robust public campaigns of any sort, have often ceded vast amount of ground to opponents (as in the case of allowing Chevron to lead the debate over Unocal), and have failed to recognize the need to develop and sustain a positive public image that will serve to support their cause when a controversy erupts. One can only trust and hope that as Chinese firms generally become more present in the North American market (as they are in sectors outside of resources) there will be a broader realization of the need for more sophisticated public relations strategies both at the firm level and even at the government level.

**Resource Insecurity and Technological Leapfrogging**

The recognition of vulnerability to outside sources of oil, base metals and other resources has led not only Chinese policies encouraging geographic diversification in supply, but also to policies encouraging diversification in energy sources domestically. With domestic oil resources likely to never again increase in their proportional contribution in meeting overall energy needs, we have seen in the past two years a significant shift in energy policy.

The two large traditional non-hydrocarbon sources of energy, hydro-electric power and nuclear, will receive huge state investments over the period of the 11th 5-year plan (2006-2011) and probably well into the future. With only approximately 30% of its hydro potential exploited to date, China will attempt to develop substantial additional amounts of energy from the resources upstream from the controversial Three Gorges project on the Yangtze River. It is also planned to expand the introduction of nuclear power, bringing on line approximately one large nuclear plant per year indefinitely.

Coal has been since the beginning of China’s development the key energy resource and it is accepted that this will remain the case indefinitely. However, environmental concerns have resulted in a policy that seeks to reduce the environmental damage caused by existing power plants through the closure of the smallest and most polluting plants, the construction only of new plants using clean coal technology and a reduction in the total proportion of energy produced directly from coal to roughly two thirds of demand from its current level of three-quarters.

Perhaps more interesting on the coal front is the very new love affair with the application of advanced technologies to make better use of China’s vast coal resources, through governmental encouragement of coal to liquids technologies and plants. Coal-bed-methane projects are being encouraged with state support. Shenhua, the large and publicly-listed coal company from Inner Mongolia, has entered into an agreement with SASOL of South Africa for two large coal to liquids plants.

Coal to DME (di-methyl-ether, which can be used to replace LPG or as a blend-stock for diesel) projects are being built in a number of locations, foreign invested coal-to diesel projects are being explored, and even methanol (also from coal) is being used increasingly as a fuel blend in the interior. This state-encouraged
experimentation may well lead to advances in technology that will be ahead of what is being applied elsewhere.

In other non-traditional energy areas, a substantial priority is being placed on solar and wind energy, which are intended to expand very substantially as contributors to national energy supply between now and 2020. The state guarantees the purchase of electricity from these renewable energy sources, subsidizes to the extent necessary the production and has assured the emergence of a dynamic and innovative market through competitive tenders, tax advantages for equipment suppliers and expanded government funding for research and technological development.

Energy insecurity as it applies specifically to oil has also had an impact on attitudes towards such new technologies as hydrogen fuel cells. Over the past year alone we have witnessed a very substantial increase in the priority ascribed to fuel cells, with more government funding and an earlier experimental program intended to see 100 vehicles on Shanghai’s streets by the 2010 World Exhibition now expanded to 1000 vehicles. The efforts at integrating fuel cells as a power source into both buses and passenger cars are likely to surpass similar efforts in any other country and may well create a situation where commercialization of the technology happens earlier in China than anywhere else.

What this Means for Canada and Canadian Businesses

The confluence of China’s growing resource appetite, and the accumulation of foreign exchange reserves at a rate never before experienced (China’s foreign exchange reserves crossed the $1 trillion mark early this week) makes it inevitable that China will become a substantially larger player in the global resource game, buying not only metals and concentrates and oil, but deposits and the companies that exploit those deposits as well.

It will not be easy for the Chinese to be welcomed as players in our oil-patch, as participants in our mining projects, as partners in the development of new deposits in our North or in someone else’s South. They will have to learn our ways, to understand the unforgiving demands and the fickleness of the public markets, and the importance of public attitudes and therefore of robust and effective public and investor relations programs. We in turn will have to be a little patient as Chinese systems and habits evolve to allow Chinese companies to play on the global stage.

To have it appear that Chinese investments and Chinese ownership are inherently less welcome than Swiss or American or Brazilian would have dangerous consequences. It would encourage rather than discourage deals with regimes whose practices we abhor or whose stated goals are to undermine the stature or security of our allies.

We should also recognize that Chinese resource insecurity represents substantial opportunities in China. Economies of scale and underlying growth potential will create attractive returns from cooperative projects in non-traditional uses of coal, in renewable energy technology, in taking that enormous step to replace the internal combustion engine with hydrogen fuel cells or other new technologies. There
are already Canadians involved in early stage coal-to-diesel projects as well as solar and wind farms, and the Europeans are heavily involved in a number of renewable projects, especially wind.

We are just at the beginning of the integration of China into the world economy. With its substantial capital and its huge population, China is going to create stresses for the developed world, and real friction as Chinese exports move up the value chain and as China emerges as a major player in the global resource game. How this friction is managed will be a major determinant of whether sustained Chinese growth will lead to greater convergence or growing distrust and hostility in US-China relations, which will almost certainly be the most important relationship in the world of tomorrow. Our natural resources, the close ties that have existed between Canada and China over the past almost forty years, and a natural affinity for Canada among most Chinese, give Canada and Canadians a real role to play in all of this.