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European Languages

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Published on Central Asia-Caucasus Institute Analyst
(<http://www.cacianalyst.org>)

THE EMERGING CHINA-AFGHANISTAN RELATIONSHIP

By Nicklas Norling (05/14/2008 issue of the CACI Analyst)

China showed little interest in Afghanistan throughout the 20th century but its growing energy and natural resource demand combined with increasing Afghan openness to foreign investors have alerted Beijing of the country's potentials. This growing interest was particularly manifested with Beijing's giant \$3.5 billion investment in Afghanistan's Aynak copper field late last year, the far largest foreign direct investment in Afghanistan's history. Reports from Kabul also indicate that additional Chinese investments are underway. Although these investments may be the engine in Afghanistan's economy, the Chinese piggy-backing on ISAF's stabilization effort is bound to be unpopular in the U.S. and Europe, though not necessarily with the Afghan government.

BACKGROUND: China showed little interest in the reconstruction of Afghanistan following the overthrow of the Taliban. Bilateral assistance and aid have thus far been extremely limited, even if bilateral trade has steadily increased. According to some sources, China has now, together with Pakistan, emerged as a main exporter to Afghanistan while a few Chinese companies were also active in Afghanistan in the immediate aftermath of Operation Enduring Freedom.

For example, Chinese companies ZTE and Huawei partnered with the Afghan Ministry of Communications to implement digital telephone switches, providing roughly 200,000 subscriber lines. China has also taken part in the Parwan irrigation project, restoring water supply in Parwar province, as well as the reconstruction of the public hospitals in Kabul and Kandahar. Moreover, the EU has hired Chinese firms for various construction projects in Afghanistan, including road restoration activities.

The political ties between China and Afghanistan also have been relatively cordial since 2001, and President Karzai has publicly reiterated his ambition to emulate "America's democracy and

China's economic success". China and Afghanistan have signed a number of agreements for the establishment of bilateral business councils and other similar institutions devoted to the development of bilateral ties.

Notwithstanding that China has increased its activities in Afghanistan gradually since 2001, Afghanistan figured overall as a relatively peripheral concern to Beijing up until 2006. In contrast to China's rapid emergence in neighbouring Siberia, Central Asia, Pakistan, and Southeast Asia, Afghanistan has remained a rather untouched square in Beijing's Eurasian hopscotch. Indeed, this disinterest could be observed throughout the entire 20th century, perhaps partly accounting for the complete disregard of China as a potential future investor in the World Bank's 2005 *Investment Horizons: Afghanistan*.

Some eyebrows were therefore raised when in 2007, China's Metallurgical group launched a \$3.5 billion bid and won the tender to develop Afghanistan's Aynak copper field in Logar province. The copper field is estimated to be the largest undeveloped field in the world and has been virtually untouched since the Soviet invasion in 1979. The investment is the far largest in Afghanistan's history and involves not only mining but also the construction of a \$500 million electrical plant and a railway from Tajikistan to Pakistan to support exploration. The mine will be in full operation in around six years, lead to the employment of 10,000 Afghans, while \$400 million of royalties will accrue the Afghan government yearly – more than half of the present yearly state budget. The mine is also estimated to generate millions of dollars in taxes and \$200 million in annual shareholder revenues. Furthermore, the shallow Aynak field is comparatively easy to develop, which speaks in favour of a fast materialization of this project.

As could be observed elsewhere in the developing world, Chinese state-owned companies launch bids almost doubling those of their foreign rivals. The mine was estimated to go for \$2 billion but the Chinese far outbid the competing Strikeforce (which is part of Russia's Basic Element group), Kazakhmys Consortium, Russia's Hunter Dickinson, and the U.S. company Phelps Dodge.

The tender forms part of Afghanistan's national privatization program which has resulted in international tenders for most of the major state-owned companies during 2007-2008, while legislation is continually being adjusted to allow for foreign investments. Will this giant investment be the starting shot of a serious Chinese emergence in Afghanistan or will the hitherto disinterested approach to Afghanistan continue?

IMPLICATIONS: There are plenty of factors suggesting that China is set to increase its investments in Afghanistan in the near future. Afghanistan has unexplored reserves of oil and natural gas in the northern parts of the country. The Afghan oil reserves were recently upgraded 18 times by a U.S. geological survey, estimates standing at a mean of 1,596 million barrels, while Afghanistan's natural gas reserves were upgraded by a factor of three, standing at a mean of 15,687 trillion cubic feet (Tcf).

Afghanistan also has large iron ore deposits between Herat and the Panjsher Valley, and gold reserves in the northern provinces of Badakshan, Takhar, and Ghazni. Major copper fields also exist in Jawkhar, Darband, and in abovementioned Aynak, located around 30 km southeast of

Kabul. All of these resource-rich areas are also situated in the relatively stable northern and northwestern regions.

Moreover, China's iron-ore demand increased close to 15 percent in the first 8 months of 2007, while copper demand surged by almost 35 percent in the same period. Natural gas demand has also increased rapidly, and China is desperately looking for overland energy supply diversification in the neighboring states in Central Asia, and potentially also in Afghanistan.

Apart from complementarity in supply and demand, the institutional development in Afghanistan is also entering a stage when it is becoming more and more prepared for hosting foreign companies; the Chinese also seem set to enter now when the time is ripe, and the state-owned companies are up for international tender. A similar timing of market entry has been demonstrated by Beijing in African countries.

China enjoys a comparative advantage to most other foreign companies, since the roof of spending is virtually limitless in sectors of strategic interest, which also speaks in Beijing's favor in Afghanistan. However, the Chinese free-riding on U.S. efforts to stabilize Afghanistan while simultaneously outmaneuvering U.S. companies such as Phelps Dodge has been met with resentment in American policy-making and military circles.

Pentagon officials reportedly stated that "the Afghan government's recent decision to award a copper mining contract [Aynak] to a Chinese company is worse than first reported." These concerns may be warranted, considering the lackluster Chinese contribution to the Afghan stabilization effort.

On the other hand, it will also generate invaluable massive foreign investments to Afghanistan which will generate employment, infrastructure, and an enhanced state budget which, in turn, is essential to provide state services and maintain central control over the country. Indeed, a number of studies, including the World Bank's 2004 report "Mining as a Source of Growth" have also identified the mining sector to be a potential engine in Afghanistan's state-building effort.

CONCLUSIONS: China remained disengaged in Afghanistan until Karzai's government recently opened up its energy, mineral, and raw materials to foreign investors. The Chinese exploration of Aynak copper field is likely the start of Beijing's drive to seize as large a share as possible of Afghanistan's natural resources. The Chinese government will likely be successful in these endeavors considering China's good standing in Afghanistan, ability to distort the market, and fiscal wherewithal to outbid its competitors.

Afghanistan has large energy and mineral resources, particularly in copper, but they should at the same time not be exaggerated. China is likely to emerge as a large investor in the country, for better or worse, and Beijing's interest in Afghanistan is likely to increase. It will nonetheless continue to be overall peripheral to China's strategic concerns compared to Pakistan and the Central Asian countries.