Brandeis University
Crown Center
for Middle East Studies

Mailstop 010
Waltham, Massachusetts
02454-9110

781-736-5320
781-736-5324 Fax
www.brandeis.edu/crown

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Middle East Brief

The Persian Gulf and China: The Growth and Limits of Economic Ties

Nader Habibi

Over the past two decades, China has emerged as one of the largest trade and investment partners of each of the eight states that border the Persian Gulf. This has occurred despite conflicts and diplomatic tensions among those states, such as the rivalry between Iran and Saudi Arabia and the ongoing dispute between Qatar and both Saudi Arabia and the UAE. Moreover, China's economic and diplomatic ties in the Gulf have rapidly expanded even though seven of the eight Gulf states are heavily dependent on the United States for their external security. Yet, China so far has largely avoided being drawn deeply into the complex politics of the region.

This Brief explores this growth in China's economic and geopolitical relationships with the littoral countries of the Gulf: Iran, Iraq, and the monarchies of the Gulf Cooperation Council (GCC).[1] It analyzes the motivations and strategic calculations of the Gulf states with respect to this rapid expansion, emphasizing China's ability to contribute to economic diversification programs. In particular, China participates in important infrastructure projects throughout the region as part of its global Belt and Road Initiative.

The Brief then turns to factors that might limit the further expansion of Gulf-China economic ties, including increasing U.S. concern about China's growing influence in the region.

The Gulf Monarchies and China's Appeal

There are strong complementarities between the Gulf economies and China's, which have led to a mutual attraction in recent decades. China's growing demand for fossil fuels is the most important factor. The Gulf region holds the largest deposits of oil and natural gas in the world,[2] and China has been a net importer of these commodities since 1993. China is now the largest importer of crude oil in the world, owing to its rapid economic growth, and in 2019 it relied on the Gulf countries for 44.2% of its total crude oil imports.[3]

As China has purchased more oil from Gulf states, it in turn has exported more goods *to* them, resulting in the rapid growth of bilateral trade between China and each country. The GCC countries' combined imports from China rose by 267% between 2000 and 2019, from $23.7 billion to $87 billion.[4] During this interval, China's share of the GCC countries' total annual imports rose from 5.08% to 16.25%. And China's share of total imports to Iraq and Iran grew even faster, so that in 2019 China accounted for 24% of Iraq's total imports and 25.8% of Iran's.[5]

The six GCC countries have similar views regarding relations with China. Aside from being a reliable long-term oil client, China has four attractive characteristics for GCC countries. First, it can be a very effective partner with respect to their economic diversification plans. All GCC countries have adopted long-term economic visions that call for reducing their dependency on oil revenues and developing strong and competitive non-oil industries. Achieving this goal requires large financial investments, and GCC governments do not want to rely solely on their oil savings for this purpose. Instead, they are all aggressively seeking foreign investment, and China is in some ways an ideal partner, with large accumulated international reserves. Furthermore, since the mid-1990s, the Chinese government has aggressively supported private and state-owned Chinese firms' investments abroad.

Second, China has made significant technological and engineering progress in recent years. Aside from offering financial capital, Chinese firms can provide the technological expertise needed for complex industrial and infrastructure projects, and they can do so at very competitive prices. In railroad and port construction, for example, Chinese firms are efficient and cost-effective. So GCC countries have welcomed Chinese engineering firms not only as foreign investors but also as service contractors. In telecommunications and internet connectivity infrastructure, the Huawei corporation, which is a leading firm offering advanced 5G mobile phone technology, is active in all GCC countries.

Third, not only are the GCC countries seeking foreign investment for their domestic diversification projects, they are also interested in foreign investment opportunities for their own sovereign wealth funds and private investors. The rapid economic growth of China in the past four decades, along with its hospitable investment climate, provides attractive investment opportunities for these countries. In the energy sector, for one, they have developed bilateral investment relations with China: While China has invested in upstream oil and gas projects in GCC countries, those countries have invested in downstream (oil refinery and petrochemicals) projects in China. Saudi Arabia, for example, invested in refineries and gasoline distribution chains in China, which enables it to process its own crude oil into refined oil products for distribution in the Chinese market.[6]

Nader Habibi is the Henry J. Leir Professor of the Economics of the Middle East at the Crown Center.

The wealthier GCC countries—Saudi Arabia, the UAE, Kuwait, and Qatar—have all accumulated large savings in their sovereign wealth funds and made sizable investments in the Chinese economy. Though the oil and petrochemical sectors dominate these investments, those four countries have also invested in several non-oil sectors, such as high-speed railways, renewable energy, and hi-tech start-ups. In addition, some GCC countries are taking advantage of investment opportunities that China is creating in other countries under its Belt and Road Initiative (BRI). This includes investments that Saudi Arabia, the UAE, and Qatar are making in the economic zone that China is constructing in Pakistan's Gwadar sea port.[7]

Fourth, owing to their small size and limited military power, the GCC countries have always sought military and diplomatic support from friendly external powers. Since China's economic and geopolitical influence on the world stage has increased significantly in recent years, the GCC countries hope that as they develop deeper economic relations with China, they can benefit from Chinese diplomatic support and military arms sales as well. The ruling political elites in the Gulf region also appreciate China's policy of non-intervention in the domestic affairs of other countries. So far, GCC leaders have been disappointed with China's support on the diplomatic front on account of the latter's reluctance to get involved in regional disputes and proxy wars: Thus, China remains neutral in the rivalry between Iran and Saudi Arabia, despite Saudi and Emirati attempts, by means of offering trade incentives, to persuade China to curtail its cooperation with Iran.[8] But as China's economic dependence on the Gulf region intensifies, it will have a greater stake in the stability of the region.

Iran and Iraq and China

Iran and Iraq share some of the same interests in China as the GCC countries, but they also have other motivations, owing to their own unique circumstances. Faced with perpetual economic sanctions and multiple regional tensions, Iran's ruling elite has long sought close diplomatic and economic relations with China. Sanctions and economic pressures have also led Iran to offer China discounts and concessions on its oil and gas sales as financial incentives. As a result, China has become Iran's largest trade partner, and the two countries have signed several long-term oil- and gas-related investment agreements. Chinese firms have also invested in several non-oil projects in Iran, such as automobile production and the construction of several urban metro railway systems.

Iran's efforts to dissuade China from cooperating with international sanctions as well as with unilateral U.S. economic sanctions against it have been only partially successful. While eager to develop deeper economic relations with Iran, China—mindful of its strong economic relations with the U.S.—has been reluctant to overtly ignore U.S. economic sanctions against Iran, and it has cooperated with international sanctions as well. At the same time, China has used its power in the United Nations on several occasions to water down sanctions against Iran and to block anti-Iran resolutions supported by the U.S.

As a result of China's delicate balancing act between Iran and its adversaries (i.e., the U.S., Israel, and some GCC countries), the expansion of Iran-China economic relations has been volatile. On several occasions, Chinese firms were forced to withdraw from, suspend, or postpone major joint projects for developing Iran's oil and gas production sector so as not to become a target of U.S. secondary sanctions. Usually these firms resume their projects after sanctions are eased or lifted. Thus, Chinese firms curtailed their activities in Iran from 2012 to 2015 on account of the international sanctions that preceded the Iran nuclear deal of July 2015 (formally known as the JCPOA). But, soon after these sanctions were lifted in January 2016, the bilateral trade and investment ties between Iran and China increased significantly, and President Xi Jinping proposed a long-term comprehensive strategic agreement between the two countries in the context of the Belt and Road Initiative. Progress toward this agreement was in turn interrupted by the unilateral economic sanctions that the Trump administration introduced against Iran in early 2018, after the U.S. withdrew from the nuclear deal. After a brief grace period, China's import of Iranian oil declined sharply in 2020, to under 100,000 barrels per day.

The supreme leader of Iran, Ayatollah Ali Khamenei, is believed to favor developing strong ties with China as a long-term strategy to garner more overt Chinese support for Iran against the United States. Consistent with this goal, Iran appears to be maximizing its participation in China's Belt and Road Initiative. Khamenei and his conservative supporters within the ruling elite are also interested in establishing closer ties with Russia and in greater trilateral cooperation with China and Russia in Central and West Asia. Accordingly, Iran is eager to join the Shanghai Cooperation Organization, which is jointly managed by Russia and China and aims to minimize U.S. influence in Central Asia. In contrast to Khamenei and his supporters, however, other factions within Iran's ruling elite instead advocate striking a balance in Iran's economic and diplomatic relations between Asia and the European Union. Consequently, the extent of Iran's relations with China and reliance on them are subject to debate and disagreement among various factions within Iran's ruling elite.

Iraq's economic relations with China, which had expanded during the 1980s, declined sharply in the 1990s as China complied with UN sanctions against Iraq and limited its trade to that allowed under the Oil-for-Food Programme. What economic ties remained suffered a severe setback after the fall of Saddam Hussein and the beginning of the U.S.-led occupation in 2003. Chinese firms played little role in Iraq's oil and gas industry until 2008–2010, when they were awarded several contracts.[9] Iraq is now a major oil exporter to China, and China is actively involved in Iraq's oil and gas sector. And most of Iraq's current political elite, despite the country's fragmented political system, has shown a positive attitude toward the expansion of economic relations with China.[10]

China's participation in Iraq's oil and gas sector is likely to expand significantly over the next several years. ExxonMobil and other American oil companies that have been active in Iraq since 2003 face several security challenges and, as a result, have recently scaled back their operations there. In 2019, Iraq's negotiations for a major oil project with ExxonMobil fell apart, and Iraq approached PetroChina as a substitute.[11] At the same time, the Trump administration has expressed concern that U.S. companies are losing out on investment opportunities that instead go to China. When Iraq's new prime minister, Mustafa al-Kadhimi, visited the White House in August 2020, the U.S. demanded more contracts for American oil firms, and several economic agreements were subsequently signed.

For its part, Iran is using its influence among Iraq's political factions to support a larger role for China in Iraq's oil sector. Iran's leaders believe that by helping China in Iraq, they can deepen their own long-term strategic relations with Beijing. Iran also views Iraq as a rival to Saudi Arabia and the UAE in the regional oil market and would like to see China rely more on Iraqi oil than on these two rivals'—if it cannot buy Iranian oil because of sanctions.

Infrastructure Development Projects

The Gulf's political elite and business leaders are paying close attention to China's Belt and Road Initiative, because it represents China's grand globalization strategy.[12] Chinese leader Xi Jinping introduced the Initiative in 2013 as a global infrastructure development plan that would make possible development of an integrated sea and land transportation network linking countries in Asia, Africa, and Europe. Through the BRI, China offers considerable financial and engineering support to infrastructure projects in participating countries.

As China attracted more than 130 countries to the Initiative, the Gulf Arab countries and Iran all included references to the BRI in their negotiations and bilateral economic agreements with China. The influence of the BRI on China-Gulf relations has gone far beyond diplomatic lip service and has had material impact on bilateral trade and investment relations. In particular, China has emerged as a major investor in the Gulf region and a supplier of engineering services to it. Not surprisingly, a sizable portion of these investments have occurred in the energy sector and include the active participation of major Chinese state-owned oil and gas companies.

Chinese firms have been involved in many large-scale infrastructure investments in the Gulf. From 2006 to 2019, China invested $100.7 billion in the six GCC countries, which accounted for 41.5% of China's total investments in the entire Middle East and North Africa region (including Israel and Turkey).[13] Saudi Arabia and the UAE were the largest recipients of Chinese investments in the region during this period, while Iran and Iraq ranked third and fourth, respectively.

The BRI has had a substantial impact on the long-term investment and economic cooperation strategies of Gulf states. Many of the non-energy investment projects that the Gulf countries are pursuing with Chinese participation focus on the construction or upgrading of roads, railways, and seaports, which will increase these countries' capacity to join the BRI network. Over the past decade, Chinese firms have contributed to the construction, development, and operations of commercial seaports around the Arabian Peninsula, including those in Kuwait, Oman, Qatar, and the UAE. China is also an active partner in the development of industrial parks (also referred to as industrial free zones) near some of these ports. The proximity of an industrial park to a seaport with modern cargo terminals makes both of them more viable. Dubai is already home to the Jebel Ali Free Zone, which is a large and operational park-port complex with a heavy Chinese presence. China is also developing two other park-port projects in the region: One is the commercial port and adjacent industrial zone joint project in Duqm, Oman; the other is the Khalifa Port and Khalifa Industrial Park near Abu Dhabi.

Kuwait selected China as its primary foreign partner for developing, in the future, Bubyan Island into a commercial port in association with a proposed mega-project called the Silk City (Madinat al-Hareer), in its northern region. If undertaken, this twin mega-project—involving the construction of an economic city for 700,000 residents across from the proposed commercial port on Bubyan Island—will eclipse other Chinese large-scale projects in the region in terms of both scale and financing.[14] The parallel Silk City and Bubyan Island projects have been under consideration for more than a decade, but progress has been slow because of political opposition from Islamists in the Kuwaiti parliament as well as the recent decline in oil revenues.[15]

Although each country considers its commercial port project beneficial for its economic diversification, the concurrent development of these multiple ports in GCC countries might result in overcapacity at the regional level. Not only will these ports compete against each other,[16] but they will also face competition from other BRI park-port projects that China is developing near the Persian Gulf. The most significant challenge will come from the Arabian Sea port of Gwadar in Pakistan, which is only 70 kilometers east of the Iran-Pakistan border.[17] This port is currently under construction and is the most important component of China's multiple BRI infrastructure projects in Pakistan, which are jointly called the China-Pakistan Economic Corridor (CPEC).

The competitive threat posed to the GCC commercial ports by the Gwadar seaport and economic zone is significant because, in addition to being developed as a major deep-water port, it will be connected by railway, commercial highways, and oil and natural gas pipelines to the China-Pakistan border. These land routes will enhance Gwadar's viability as a major transshipment (land and sea) hub in the BRI network.[18] Additionally, to the west of the Arabian Peninsula, China is developing the Suez Canal economic zone and the TEDA-Suez industrial park in Egypt,[19] which are also likely to compete with GCC ports as transshipment hubs for China's trade with the Middle East and Africa.

In contrast to these park-port projects in the GCC countries, most infrastructure projects that China has undertaken in Iran are road and railway construction projects. By developing its transit rail system, Iran is likely to play an important role in developing BRI land transport corridors that connect China and Central Asia to Europe and Africa. A railway line that connects Iran, Turkmenistan, Uzbekistan, Kazakhstan, and China became operational in 2016, but Iran's rail transit system needs considerable upgrading to become suitable for high-speed cargo trains. China has participated in several projects to modernize Iran's existing railway network and construct new lines[20]—but these projects have suffered occasional setbacks on account of multilateral economic sanctions as well as the U.S.'s unilateral ones.

To maximize economic gains from rail transit, Iran has given a high priority to developing and upgrading its east-west rail network, which is already linked to China's rail network through central Asia and to the European rail system through Turkey. Chinese firms are currently involved in electrifying a 900-kilometer segment of this route between Tehran and Mashhad.[21] Both Iran and China are also interested in developing an extension from Iran's east-west railway toward Iraq and, eventually, to Syria.[22] These plans call for one railway from southern Iran to Basra City in Iraq[23] and another from western Iran to the Kurdistan Region of Iraq; both of these routes could be extended into Syria. The Syrian government had nearly completed a railway to the Syria-Iraq border before the civil war began in 2011, but this railway has since been extensively damaged. Though the government of Syrian President Bashar al-Assad has expressed an interest in attracting Chinese firms to help repair and upgrade this railway, significant progress does not seem possible so long as the Syrian conflict continues.[24] Moreover, the United States or Israel might disrupt any transportation infrastructure projects between Iraq and Syria that could be utilized by Iran for the transportation of troops and military hardware.

In Iraq, China is active in several infrastructure projects, and recent economic agreements are expected to further expand China's participation in reconstruction projects there. During a visit to China in 2015, then-Iraqi Prime Minister Haider al-Abadi signed a strategic partnership agreement with China to support Iraq's involvement in the BRI. This was followed by another high-level visit to China in September 2019, during which Iraq formally signed a multi-billion-dollar twenty-year oil-for-reconstruction agreement.[25] According to this agreement, the proceeds from the sale of 100,000 barrels of crude oil per day will not be paid in hard currency to the Iraqi government.[26] Instead, the proceeds will be used by the Chinese government to cover the cost of infrastructure projects that will be executed by Chinese firms.[27] Iraq has defined three priority sectors for these projects, two of which are highways and international roads and railways, ports, and airports.[28]

This oil-for-reconstruction arrangement offers Iraq several advantages in its dealings with China. First, by covering the cost of these projects through direct oil delivery, it enables Iraq to avoid borrowing from China to finance them. At the same time, it reduces the potential for corruption and for embezzlement of funds that would have been transferred if China paid for its oil imports first and then signed separate contracts with various Iraqi ministries for these projects. In Iraq's fragmented political system, large quantities of development funds have been lost to corruption and mismanagement since 2003.

In a related development, the government of new Iraqi Prime Minister Mustafa Al-Kadhimi is pushing forward a law that will create a new reconstruction council to supervise oil-for-reconstruction projects. The main objective would be to further reduce corruption, as well as the bureaucratic inefficiencies that might arise if Chinese firms have to deal directly with various ministries and provincial governments.[29] Chinese firms are also involved in several projects to construct new thermal power plants in Iraq and upgrade existing ones;[30] the country has persistently suffered from a shortage of electricity, and the completion of these plants is a major priority.

Potential Challenges to China's Gulf Strategy

Although economic ties between China and the eight states of the Gulf region have grown steadily over the past two decades, several factors might make further expansion more difficult and even lead to some retrenchment. For one thing, the multiple disputes among countries in the region might limit the region's overall ability to benefit from the connectivity offered by BRI projects. In other regions, such as Central Asia and Africa, participation in the Initiative will not only increase each individual country's economic linkages with China, but it is also expected to result in intra-regional transportation efficiencies and more economic cooperation among neighboring countries. That likely will not be the case in the Gulf region, however, because of regional rivalries. For example, the UAE and Saudi Arabia will be unable or unwilling to take advantage of Iranian, and perhaps Iraqi, transit routes for connections to Central Asia and parts of the Levant. Disputes and rivalries within the GCC have likewise slowed the development of intra-Gulf transport networks, such as the 1,350-mile GCC Railway project, which was announced in 2005 but has seen only partial progress.

Both domestic and regional conflicts have adversely impacted the progress of BRI projects, especially in Iraq and Iran. Many Chinese projects in Iraq were suspended from 2014 to 2017, for example, because of the war against the Islamic State (ISIS). More recently, in 2019, protests and mass demonstrations in Iraq against corruption and economic mismanagement, as well as the lack of coordination among political factions, prevented the Iraqi government from moving forward with the oil-for-reconstruction program described earlier.

Another factor that is likely to have a significant impact on the direction and pace of the Gulf countries' economic relations with China is the U.S. attitude toward those relations. U.S. sanctions on Iran have consistently cast a shadow on China's economic relations with the country, limiting the volume of bilateral trade and investment. And China's willingness to comply with those sanctions will depend on the overall state of U.S.-China relations, which have deteriorated since 2018. If these tensions escalate, China might have less incentive to comply with U.S. sanctions. Yet, it is also possible that bilateral relations between the U.S. and China will improve under a Biden administration.

The U.S. is also increasingly concerned about China's relations with American allies in the region. The U.S. has generally kept silent about China's burgeoning economic ties with Iraq and with GCC countries, but there are indications that this is changing—not only as a result of recent tensions in U.S.-China relations, but also reflecting a realization that China is emerging as a competitive technological and economic rival in these markets. The U.S. is particularly worried about the growing presence of high-tech Chinese firms, such as Huawei, in GCC countries.[31]

Until recently, the U.S. and major European countries enjoyed a strong competitive advantage in advanced technologies, while China had an advantage in the low-cost, labor-intensive manufacturing sector. This is no longer the case, and China is now a major global competitor in high-tech sectors, such as 5G telecommunications. Consequently, in addition to energy and core infrastructure industries, China is also offering GCC countries high-tech investments, in direct competition with U.S. firms.

In addition to economic competition, the U.S. is also concerned that Chinese high-tech firms operating in the region might engage in digital espionage for the Chinese government and hence pose a risk to the U.S. military and to other U.S. interests. The U.S. engages in extensive security cooperation with GCC governments, which are ever more reliant on Chinese technology for telecommunications and high-speed internet.

The ruling elite in the GCC countries and some elite factions in Iraq are likely to take these growing U.S.

concerns into account as they consider the further expansion of their economic and technological cooperation with China. In the GCC countries, this will be in part because, for them, the U.S. is considered to be a long-term security ally, whereas China is seen as only a "neutral" economic partner. U.S.-GCC security relations are more than five decades old, and GCC countries are likely to regard them as stable even if the U.S. reduces its security presence in other parts of the Middle East. The U.S. will therefore continue to enjoy some amount of diplomatic and commercial leverage with GCC governments.

So far, China has shown a strong commitment to its policy of geopolitical neutrality and noninterference. While GCC leaders appreciate China's non-intervention in their domestic affairs, they have come to realize that, unlike with respect to the United States, they cannot count on China for a strategic alliance or as a security partner. In this context, economic relations with China will be welcomed, but GCC governments are unlikely to offer trade or investment privileges to China as compensation for military protection, as they have done with the U.S.[32] Furthermore, they are likely to be responsive to U.S. concerns about their reliance on Chinese technology in sensitive fields, such as 5G telecommunications infrastructure.[33]

Conclusion

The countries of the Persian Gulf expanded their economic relations with China over the past twenty years, reaching record high levels. From their point of view, China is not only a reliable long-term oil and gas client, but also an attractive trade and investment partner that does not interfere in their domestic affairs or criticize them on human rights issues. Initially, some Gulf countries saw China as a potential strategic and security ally. Over time, however, these expectations have been dampened, and these countries have come to terms with China's continued policy of neutrality with respect to various Middle East conflicts and its reluctance to challenge the U.S. military position in the region.

The Gulf countries are expected to further expand their economic relations with China in the context of the Belt and Road Initiative. The ongoing disputes and rivalries among the Gulf countries, however, will limit their ability to benefit from the intra-regional connectivity that this initiative has enabled elsewhere, as in Central Asia. The GCC countries' reliance on China for some advanced technologies, such as 5G mobile networks, might also be challenged by the United States in the coming years.

Endnotes

1 The Gulf Cooperation Council (GCC) consists of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE).

2 Based on the most recent estimates by the U.S. Energy Information Administration, total proven crude oil reserves of the eight countries of the Persian Gulf stood at 798.7 billion barrels in 2019, which was equivalent to 48.1% of the world's total proven reserves. See: U.S. Energy Information Administration, International database.

3 China imported $238.7 billion worth of crude oil in 2019, of which $105.5 billion (44.2%) came from the Persian Gulf region. See Daniel Workman, "Top 15 Crude Oil Suppliers to China," World's Top Exports, n.d.

4 The GCC's imports from China predominantly comprise industrial products such as machinery, consumer electronics, metals, and textiles.

5 The trade data reported in this section were calculated based on bilateral trade data as reported at International Monetary Fund, IMF Data, Direction of Trade Statistics (DOTS). (Data downloaded on June 4, 2020).

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23 The construction of this 32-kilometer link between the Iraqi and Iranian railway networks began in 2014. Iran completed its portion, but no progress has been made on the Iraqi side, even though Iran has agreed to finance and oversee the construction of the Iraqi portion. See "Construction of Major Iran-Iraq Railway 'Will Begin Soon,'" *Iraq-Business News*, July 27, 2020.
24 Mykola Zasiadko, "Syria Plans to Join New Silk Road," *Rail Freight*, December 19, 2019.
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26 Iraq's daily oil exports to China exceed this 100,000 figure, but as of now, only this amount has been designated for the oil-for-reconstruction program.
27 Salam Zidane, "Iraq, China Launch 'Oil for Reconstruction' Agreement," *Al-Monitor*, October 10, 2019.
28 The third sector is large-scale residential and commercial real estate. See Zidane.
29 Majda Muhsen, "Iraq's New Reconstruction Council to Oversee Oil-for-Projects Deal with China," *Zawya*, May 6, 2020.
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02454-9110

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