The “New” Russia-China Relations -Implications for the EU

Summary

- Russia is increasingly turning towards China as a result of Western sanctions. But although there is much talk and diplomatic support there are few concrete results due to Russia’s structural economic problems.
- This short-term ‘axis of convenience’ could, however, develop into a more strategic alliance in the future given the right incentives on both sides.
- The EU has taken a relaxed position to this new relationship. This may not be possible in future and the EU should reflect on how closer ties between Russia and China might affect important EU interests.

1 Introduction

For cultural and geographical reasons, Russia and China have always faced in different directions: China towards Asia and Russia towards Europe. Their relations before the 20thC were cautious with few close ties. When the Chinese Communist Party took power in 1949 it led to a decade of close relations between the two major communist powers. But China was reluctant to play the little brother role and following the death of Stalin in 1954 relations began to deteriorate. In 1960 Khrushchev decided to withdraw Soviet economic and technological support. The following year Mao accused the Soviet leadership of revisionism and the Sino-Soviet alliance was over (although some Western experts considered this was a plot to confuse the West).

Relations continued to deteriorate leading to serious border clashes along the Ussuri River in 1969. This event led both China and the Soviet Union to explore alignments against each other with the US. Relations began to improve in the late 1970s when Deng Xiaoping became leader. By 1989 the process of rapprochement was complete allowing Gorbachev to visit Beijing shortly before the Tiananmen Square disturbances. He refused to involve the USSR in the sanctions the western powers imposed on China following Tiananmen. Yeltsin, regarded with suspicion in Beijing for promoting the break-up of the Soviet Union, remained a firm advocate of good relations with China and worked to build on the breakthrough achieved in the 1980s. In 1997 Jiang Zemin already spoke of Russia as China’s key strategic ally. In 1998 the two countries acted jointly for the first time in the UNSC to oppose the US bombing of Iraq. Subsequently both countries strongly opposed the US led attacks on Yugoslavia in 1999 and on Iraq in 2003. Under Putin, cooperation between Russia and China has steadily intensified. The long standing border issue was finally resolved and Russia and China began to deepen their cooperation in global affairs.
This report reviews the new Russia-China relationship under the impact of Western sanctions, focusing on the possible mid- and longer-term developments. It also discusses the implication of this new relationship for the EU.

2 Russia’s Accelerating Pivot to the East

The deterioration in Russia’s relations with the EU and US following Moscow’s aggression in Ukraine, and the corresponding need to find an alternative partner, was a powerful factor in accelerating Russia’s pivot towards China. Although the sanctions hastened Moscow’s tilt to the east, Putin officially announced Russia’s Asia pivot in June 2013 even before Western sanctions were imposed. The Kremlin announced ambitious plans to boost the Russian economy by switching its focus to the Asia-Pacific region. The aim was to develop the depressed Far-East regions by investing in massive new infrastructure including a new gas pipeline to China. From the geopolitical perspective, the Asian pivot was initially meant to add to the Europe-Atlantic dimension of Russia’s foreign policy. Within the Asia-Pacific, Moscow was looking for a balance in relations with all the key powers (China, India, and Japan). Until June 2014 there was little progress to show in the Russian pivot. Moscow was still concerned at the growing imbalance in relations with China.

But the triple whammy of Western sanctions, the collapse in the oil price and diplomatic isolation (Russia excluded from the G8) meant a step change in Russia-China relations. Economic factors played a key role. The World Bank’s 2015 report on Russia - *The Dawn of a New Economic Era?*  forecasts a negative outlook for the Russian economy, with respective GDP growth of -3.8% and -0.3% in 2015 and 2016.

*Figure 2-1 The GDP growth outlook (GDP growth Percent, y-o-y)*
As shown in the above figure, although Russia managed not to fall into recession in 2014, the World Bank predicted that recession in 2015 is inevitable. The worst case scenario is that Russia may suffer as high as -4.6% of GDP contraction in 2015, with the best case scenario of -2.9% of GDP contraction. The western sanctions have played a crucial role in the ongoing economic recession of Russia, sharply reducing Russian companies’ access to western technology, investment, and credit, especially in the critical energy sector. In addition the plunge in the price of oil has sent the ruble into free fall. As shown in the figure below, the oil price and the ruble’s exchange rate dropped sharply in the second half of 2014, and so far the trend continues albeit with a recent slight strengthening of the ruble. Since it takes time for the full impact of the sanction to be revealed, the damage is certainly going to be worse in the mid-term.

**Figure 2-2 Oil Prices and ruble exchange rate in 2014**

![Graph showing oil prices and ruble exchange rate in 2014](source: World Bank 2015)

### 3 Russia Pivot to the East Made Little Progress until the Ukraine Crisis

#### 3.1 Russia and China are still competitors in many ways.

The growing gap in economic power between Russia and China is viewed with great concern in Moscow. In 1994, the GDP of Russia ($435 bn) and China ($441 bn) were similar, but in 2004, China’s GDP (($1640 bn) was already four times of Russia’s ($430 bn) and in 2014, China’s GDP (($9240bn) is almost five times that of Russia’s ($2096bn), and the gap is likely to grow bigger. Now China is the second largest economy in the world and Russia is at the bottom of the top 10.
Russia paid little attention to the rapidly growing Chinese market during the past decade. It accounts for just over 2% of China’s external trade. Most of Russia’s trade with China comprises oil and gas exports in exchange for Chinese manufacturing and consumer imports. China has shown little interest in Russian industrial products except for military goods. Both sides were unhappy and frustrated at the low level of trade. Russia often targeted illegal Chinese entrepreneurs while imposing an informal ban on Chinese investing in major infrastructure projects.

**Competition in Central Asia**

China’s influence in Central Asia, traditionally allies of Russia, has been growing in recent years and is a challenge to Russia’s plans for the establishment of the Eurasian Economic Union. China has since countered with the New Silk Road initiative and Asian infrastructure investment bank (AIIB). Beijing is rapidly developing closer ties with Central Asia using financial diplomacy to good effect. This in turn has led to growing concern in Moscow about who will be the dominant external power in the region.

**Security and defence issues**

There has often been tension between Russia and China over their 2200 mile land border (see above). Although the border was settled in 2004 there remain concerns not least because of the huge population imbalance in the Far East. The sale of military equipment to China always causes some soul-searching in Moscow, not simply because they might be used against Russia but because China has a record of buying Russian military weapons and defence systems, then copying them and selling them to third parties at a cheaper price. Russia has also been nervous about China’s cyber security technology. No Chinese telecommunication companies were allowed to invest in Russia until 2013.

**People to people relation**

There are large cultural differences between China and Russia and people to people contacts, for example, in education and tourism are limited. There are far fewer Chinese students in Russia than in the EU, US or even Australia. Russian students only started to be interested in studying in China in the past decade. During Xi’s 2013 visit to Russia, the two countries pledged to raise the total number of their students in each other’s countries to 100,000 by 2020. Even then it will be still far less than the exchanges between Russia and the EU or between China and the EU. For bilateral tourism, in 2013, 4 million (less than 10%) Russian tourists travelled to China. In 2014, less than 358,000 Chinese tourists went to Russia, much less than the EU tourists.
3.2 Russia has stronger ties with Europe compared to China

Economically, the EU is the first trading partner of Russia. In 2013 the EU accounted for 57% of Russian exports and 46.5% of Russian imports. In the energy sector, the EU imports from Russia more than €100 billion of crude oil and oil products, one third of the EU’s total oil imports. In terms of gas, in 2013, Russia exported 71% of its gas to Europe, with the largest volumes to Germany and Italy. Six Member States (Bulgaria, Estonia, Finland, Slovakia, Latvia and Lithuania) depend on Russia as a single external supplier for their entire gas imports. The supplies from Russia accounted for 39% of EU natural gas imports. While EU imports from Russia are dominated by oil and gas, EU exports to Russia are dominated by various products: machinery and transport equipment, chemicals, medicines and agricultural products. Furthermore, the EU is the most important investor in Russia. It is estimated that up to 75% of Foreign Direct Investment (FDI) stocks in Russia come from EU Member States.¹ Compared to the EU, Russia’s economic ties with China are far less important (see below). China is a not a sophisticated trading partner as the EU and invests much less than the EU in Russia. China imports much less oil and gas from Russia compared to the EU.

Table 3-1 Russia’s Economic Ties with EU and China (based on 2013 data)

<table>
<thead>
<tr>
<th>Trading Partner of Russia</th>
<th>FDI stock in Russia</th>
<th>% of Russian exports</th>
<th>% of Russian imports</th>
<th>Gas import</th>
<th>Oil import from Russia</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU</td>
<td>First</td>
<td>75%</td>
<td>57%</td>
<td>46.5%</td>
<td>Russia is the first supplier of EU’s gas imports</td>
</tr>
<tr>
<td>China</td>
<td>Second after EU</td>
<td>Not in top 10</td>
<td>8.1%</td>
<td>15%</td>
<td>Russia is the fourth supplier of China’s gas imports</td>
</tr>
</tbody>
</table>

Source: UN comtrade

Culturally, Russia has stronger ties with Europe as well. For instance in 2013, 41 million tourists travelled from Russia and of these, 32 million (77%) travelled within Europe. In 2014, there were more than EU tourists 700,000 tourists (318,600 from Germany, 120,900 from the United Kingdom, and 92,600 from Italy) went to

Russia. The EU is also a favourable place where Russian parents send their children to study, especially in the UK, Germany and the Netherlands.

4 Friends of Convenience?

The political and economic impact of the Ukraine crisis pushed Russia to be more serious in its pivot to Asia, especially towards China. Beijing, which has never openly criticized Russia in the Ukraine crisis, has also welcomed the sudden increase of attention from Russia. Putin and President Xi have established a close personal relationship (they will meet five times in 2015) and a number of high profile deals in oil and arms were concluded. Other infrastructure projects are under discussion.

This remarkable geo-political change possibly marks an end to Russia’s efforts since 1991 to seek Western integration. Under Putin Russia has taken a more nationalist course and the imposition of sanctions accelerated the shift towards China, the only large economy left which did not impose sanctions on Russia. In addition Beijing was prepared to offer its fellow UNSC partner diplomatic support in their common efforts to prevent ‘Western domination’ of the international system.

4.1 What is new in Russia-China relations in the sanctions era?

Xi and Putin’s meetings accelerated major deals. Putin visited Beijing in May 2014, after the first two rounds western sanction (March and April 2014). This trip closed the decade-long negotiated "eastern route" gas deal between Gazprom and China National Petroleum Corporation (CNPC). The agreement provides a 30-year, US$400 billion deal for Russia to supply China with 38 billion cubic meters of gas per year to be transported from remote fields in eastern Siberia via a planned 4,000-kilometer pipeline.

Putin and Xi met another three times after the third round of sanctions (July 2014). Even though these bilateral meetings were held on the multilateral platforms—the BRICS summit in July; Shanghai Cooperation Organisation (SCO) summit in September, Asia Pacific Economic Conference (APEC) in November-- each meeting was taken by Xi and Putin as a chance to deepen Russia-China ties. In the SCO Summit, a project plan of building a high speed train to connect Beijing and Moscow has been finalized. The line will pass through China, Kazakhstan and Russia and cover more than 7,000 km. (Beijing announced that the estimated budget for this

project is $242 billion). During the APEC summit, multiple deals have been made including a joint development zone in the Russia Far East region and several power plants cooperation in the region. Russian hydroelectricity generator RusHydro signed several agreements worth $4.9 billion (230 billion rubles) with Chinese power companies. RusHydro will partner with the “Three Gorges” company to finance, construct, and operate, hydroelectric power plants in Russia’s Far East in order to export electricity to China. A framework agreement of the “western-route” oil project between Gazprom and CNPC was also signed. China National Oil and Gas Exploration and Development also purchased a 10 percent stake in Rosneft subsidiary Vankorneft’s second-largest oil field, Vankor.

**Russia opened its market to Chinese investment**

Anticipating much less investment coming from the EU under the sanctions, Moscow hopes China will increase its investments in Russia. Russia relaxed its informal ban on Chinese investment leading Huawei to enter the Russian market in 2014. The Russian Economic Development Minister Alexey Ulyukaev said he hopes to attract seven times more Chinese investment by 2020.

**Yuan and Ruble swap**

To help Russia to overcome its economic difficulties, China and Russia signed an agreement (in October 2014) allowing Russia’s central bank to borrow up to 150 billion Chinese Yuan ($24.4 billion) using currency swap agreements and the agreement was put into action in December 2014.

**Security and Defence cooperation**

China deploys a number of the Soviet-era S-300 defence systems (European arms embargo was imposed on China following Tiananmen Square Massacre in 1989) and China had long wanted to buy Russian S-400 air and missile defence systems. But the deal had not been approved because Russia is concerned that China will copy the S-400 and develop their own system despite China offering comprehensive intellectual property protection (IPP) terms. It seems the western sanctions accelerated the negotiation, and in early April 2015, Putin approved the deal, the first to a foreign buyer. Beijing will buy 6 S-400 defence systems worth US$3 billion with the expected delivery in 2016. Russia and China also strengthened their cyber security cooperation signing a deal on international information security under the new concept of security put forward by both countries.

**Other cooperative moves on the global level**

The BRICS Development Bank (BDB) agreement was signed at the BRICS Summit in July 2014. The authorized capital of the bank is US$100 billion, and the initial capital
is US$50 billion. The reserve funds for BRICS countries are US$100 billion, among which China provides US$41 billion and Russia provides US$18 billion. In March 2015, Russia also became a founding member of the Asian Infrastructure Investment Bank (AIIB).

4.2 Potential Mid- and long-term development

Both China and Russia have incentives to deepen their relationship, moving to what one expert has called a “soft alliance.”

To begin with, both China and Russia benefit from the long term energy cooperation. China imports around 80% of its energy from the Middle East and West Africa. This represents a strategic vulnerability of China’s energy security. In the event of conflict China’s vital oil supplies could be cut off by the US navy. Russia along with Central Asian countries, on the other hand can secure China with oil and gas supplies since overland pipelines are easier to protect. Russia also needs China to leverage the West in energy sales. In the long run, China could be Russia’s biggest energy customer instead of the EU. When both the Russia-China “western-route” and “eastern-route” pipelines are completed, they will deliver up to 68 billion cubic meters of gas to China annually, which will make China the largest consumer of Russian gas. Furthermore, a third gas project is also under discussion. Gazprom is looking into the possibility of building a pipeline from Vladivostok to north-eastern China. The advanced payment and a 30 years steady cash flow from China will help the stressed Russian oil and gas companies in the mid and long term.

More importantly, as neighbours, Russia and China have strategic importance in defence and security. Were the soft alliance to grow harder,
China will be able to protect its northern border with less resources and switch its focus on expanding its influence to the south and the east where China has growing territorial disputes with many of its eastern and southern neighbours, including Japan, Vietnam, the Philippines, and India. A solid tie with Russia may also provide China the diplomatic support in case the disputes worsen. There is signs that military cooperation between Russia and China will be further strengthened. They have held joint naval drills since 2012 and have plans to jointly modernize Russia’s Mi-26 Soviet-era helicopter to dual use civilian-military helicopters. There are plans to cooperate to create a lunar base.

**There are rooms for more active relations in trade, investment and people.** Both the China New Silk Road initiative and Russia’s Eurasian Union initiative are at their beginning. There is potentially great scope for cooperation in the two initiatives. The CPC has also started to promote a more favourable image of Russia while the Kremlin controlled media has also helped create a relatively positive image of China in Russia. The recent support Russia gets from China also made Russia’s pivot towards China popular in Russia.

The lack of bureaucratic efficiency in Russia could be the biggest challenge in realizing the economic and cultural potential between China and Russia. That is also the reason Russia’s China pivot made little concrete progress until now. How the various signed agreements will be implemented in the coming years will be a test of how capable Russia can hold its end of the deals.

**Personal ties may play a more important role in the future.** Putin and Xi are growing their personal ties. Xi’s first state visit was Moscow in March 2013 when Xi openly expressed his appreciation of Putin’s personality. As a return, Xi was the only leader invited to Putin’s birthday party during the 2013 APEC summit. Putin had told the public that Xi joined the party at 11pm with a cake and they drunk vodka together, which is a sign of personal trust in both Chinese and Russian culture. Putin seemingly has more trust in Xi than in any Chinese leader before him (Putin has worked with Jiang and Hu) and any current European leader (Putin’s personal relationship with Merkel has been disrupted because of the Ukraine crisis). They will be seeing each other several times in 2015: in Moscow in May (celebration Russian’s victory day, Xi was at Putin’s side during the parade and subsequent ceremonies although most western leaders declined Putin’s invitations), in Ufa in July (SCO), and in Beijing in September (China’s end of WWII celebration).

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3 Both the Russian and Chinese media reported a conversation in which Xi told Putin “I feel that our personalities are quite similar” when Xi visited Russia in March 2013.
In the longer term, Xi and Putin’s personal relations may become a crucial determinant of the new Russia-China relations. Unlike Obama or Merkel or any other EU leaders, both Putin and Xi do not have to bother with elections and are both likely remaining in office for a long time (Xi estimated till 2023, Putin 2024).

The political elites value the new relationship. China is aware of Russian concerns that it is the junior partner due to China’s economic strength so Chinese elites describe the relationship as cooperation between equals under “new great power relations.” Russian political elites have also began taking the new friendship between Russia and China more seriously since the sanctions. Putting aside the fear for China and the suspicion of the “equal partner” status, these elites know that both in the short term and the long term, the Russian economy can benefit from more cooperation with China especially when squeezed by the West.

5 Implications for the EU

The new relationship between Russia and China, stemming from the Ukraine crisis, could have wide-ranging implications for the EU. The most extreme speculation is that Russia and China could potentially form a defence alliance, the equivalent of a "Eurasian NATO" which would be a threat to both the EU and US. But so far the EU seems unimpressed by the new Russia-China relations. The EU believes a real alliance between Moscow and Beijing is highly improbable because of the fundamental conflict of interests between the two, plus Russia’s much closer ties with Europe cannot be replaced by China anytime soon. The EU believes the new relationship is not strategic but responsive.

Geopolitically, the most important implication for the EU is that with the support of China, the post-communist Russia’s 25 years aim of integration with the EU might be over. In the new setting, Russia is seeking to expand and deepen its relations with Asia with China the main but not exclusive focus. Russia is also courting other Asian countries such as Vietnam, India, and Japan and seeking to strengthen its influence in Central Asia. In the long term, given the right incentives, Russia and China may also integrate their plans for a new Silk Road and the Eurasian Union not only economically but politically. Putin or his successor may no longer desire a greater Europe but a greater Eurasia instead. Looking at the economic realities though, Russia cannot modernize via the Eurasian Union. It also has no capability (nor desire) to modernise itself copying the “China model” even with support from China. Russia, therefore, cannot totally ignore the EU. But the longer the Ukraine crisis continues, the stronger the Russia-China axis may grow, making it more and more difficult to restore EU-Russia ties.
With easy and cheaper access to Russian natural resources and military technologies, China’s influence in global affairs is likely to increase. How it uses this influence will be a matter of concern to the EU.

**Economically**, the sanctions have led to a slight reduction in EU growth (down 0.2-0.3% in 2014 and 2015). Given the uncertainty surrounding sanctions many European companies have stopped trading or investing in Russia. This gap has been filled by Chinese and other Asian companies. China is not only shipping food which would have been shipped from the EU, China is also providing cheap finance to Russian companies. Russian oil and gas companies are getting advanced payments from China. China is also ordering many more weapons and military jets. The Hong Kong and mainland China stock markets are also providing access for Russian companies to be listed. If the sanctions continues long enough, the European companies may lose their market in Russia for good. It is true that in the short term, Asia, especially China alone, will not be able to compete with the EU with regard to the economic and political ties with Russia. But by increasing economic cooperation with China, Russia has felt much less impact from the sanctions than expected. China’s support has already undermined the effects of the sanctions.

**There is also an indirect way** that China’s friendship with Russia is undermining Western sanctions. Chinese companies may finance European companies (such as the French energy giant, Total) who face sanctions for doing business with the Russians. Were this business model to be used more often, then the effects of sanctions would be further undermined.

China’s 16+1 initiative can also decrease the effect of sanction to Russia. The 16 Central and Eastern European countries involves important parts of the former Warsaw pact, together with countries like Serbia and Greece who are traditionally close to Russia because of the "orthodox connection". Their respective issues with the EU may push them towards Russia and China.

**What should the EU do?**

To preventing China from further undermining the effect of sanctions the EU needs to push for the full implementation of the Minsk agreement, not an easy task given the very different interpretations of the agreement between Kiev and Moscow. If and when the agreement is fulfilled the EU will be able to drop the sanctions against Russia. At the same time the EU should maintain pressure on China not to undermine the sanctions as they were taken because Russia had violated the territorial integrity of another state, something China also strongly opposes (at least in principle).
The EU also needs to consult with the US and others about how to ensure that China has its fair share of influence in the current international institutions. A modest increase in China’s voting rights in the IMF has been blocked by the US Congress for a number of years. This is not only unacceptable but counterproductive.

Finally the EU must define and promote its own interests in the wider Eurasia region. This has a Russian dimension, linked to a potentially new relationship between the EU and the Eurasia Union (including Afghanistan and the potential for EU-China cooperation there); a Central Asia dimension with the EU finally implementing its strategy for the region agreed some years ago; and a Chinese dimension taking into account the possibilities to develop synergies along the new Silk Road.