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BRIEF

# A “SOFT ALLIANCE”? RUSSIA-CHINA RELATIONS AFTER THE UKRAINE CRISIS

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## SUMMARY

After the European Union and the United States imposed sanctions on Russia in response to the annexation of Crimea, President Vladimir Putin made a dramatic turn towards China in order to keep the Russian economy – and his regime – going. For China, the Ukraine crisis was a unique opportunity to increase its access to Russia’s natural resources, particularly gas, gain contracts for infrastructure projects and new markets for Chinese technology, and turn Russia into a junior partner in the relationship between the two countries. The relationship is likely to become stronger and more comprehensive. Though they are unlikely to develop a formal alliance, China and Russia may form a kind of “soft alliance”.

The developing relationship between China and Russia could provide Putin with a way to undermine the effect of sanctions and may also help Beijing become even more assertive both regionally and globally. In the long term, current developments could make Russia even more dependent on China. The EU has two options: to work with the United States to increase the pressure on Russia by sanctioning Chinese companies that do business with sanctioned Russian entities and individuals; or, alternatively, to try to undermine the increasingly close relationship between Moscow and Beijing by encouraging other Asian countries such as Japan and South Korea to co-operate with Russia in order to decrease its dependence on China.

The Ukraine crisis has not only changed the relationship between Russia and the West but also led to more intense cooperation between Moscow and Beijing. After the European Union and the United States imposed sanctions on Russia, President Vladimir Putin made a dramatic turn to China and signed a series of deals, including a \$400 billion deal to export gas to China last May. Moscow is now attempting to reorient its entire economy towards Asia as a way to mitigate the negative impact of Western sanctions. For China, meanwhile, the Ukrainian crisis provided a unique opportunity to increase its access to Russia’s natural resources, particularly gas, gain contracts for infrastructure projects and new markets for Chinese technology, and turn Russia into a junior partner in the relationship between the two countries.

This brief examines the dynamics of the Russia–China relationship and explores possible implications for the EU. Based on interviews in China and Russia, it explores how officials, oligarchs, managers of state-owned companies, and experts from both sides see the relationship. It argues that the relationship between China and Russia is likely to become stronger and Moscow’s dependency on Beijing will grow. For Russia, China will not replace Europe, but could provide a lifeline that will keep Putin’s system going. The Kremlin’s logic is concentrated on regime survival rather than long-term national interests, which makes it easier to submit to Chinese pressure. China is also interested in keeping Putin’s regime in place in order to provide cover for its growing confrontation with the US and its allies. If the trend is sustainable, Russia will turn into China’s junior partner.

However the Russia–China relationship develops in future, it will have a significant impact on European interests. Most immediately, it could undermine the impact of sanctions against Russia. The link with China will not restore Russia's economy to the state it was in before the war in Ukraine, but it could provide a minimum level of wealth to sustain the confrontation with the West and keep Putin in the Kremlin. In the long term, the relationship could also have other, even more serious implications for Europe. In particular, it could strengthen China, which could become even more assertive in its neighbourhood. The closer relationship between China and Russia could also have implications for the liberal international order. Until now, the European Union has tended to view its relations with Russia and China as completely separate from each other. But it now needs a coherent long-term strategy towards both, which could involve making tough choices.

### A recent history of Russia–China relations

In order to understand the significance of current developments, it is necessary to understand the history of Russia–China relations since the end of the Cold War, which can be divided into three periods. The first, from 1989 to 2000, began with the normalisation of Sino-Soviet ties after the end of the Cold War and ended with Putin's election as president. The second, from 2000 to 2008, was the period of Putin's two presidential terms. The third, from autumn 2008 to spring 2014, includes both the presidency of Dmitry Medvedev and the first two years of Putin's third term.

After the end of the Cold War, Sino-Soviet ties were normalised. But after the collapse of the Soviet Union in 1991, the two countries ceased to be a priority for each other: Russia was struggling with economic difficulties, state-building, and the Chechen war; China was trying to attract foreign investment and build an export-driven economy while maintaining state control in key sectors. Political cooperation between Moscow and Beijing was mainly concentrated on regional issues such as the first summit of the "Shanghai Five" in 1996, which included China, Russia, Kazakhstan, Kyrgyzstan, and Tajikistan, and was focused on border delimitation. Although personal ties between Boris Yeltsin and Jiang Zemin were good (Jiang belonged to the last generation of Chinese leaders educated in the USSR), the two leaders had little to talk about. In 1993, China still was Russia's second-largest trading partner, but by 1994 it had fallen into tenth place; Russia was even less important to China.

However, in the late 1990s, there was an explosion of unregulated cross-border trade. Inhabitants of the Russian Far East, once a strong military outpost of the Soviet Empire in Asia-Pacific that was nearly abandoned by Moscow in the 1990s, embarked on trade with neighbouring Chinese provinces. On the other hand, Chinese entrepreneurs from the depressed industrial north-east region stormed bordering Russian regions in search of opportunities – many of them illegal. This black-market activity helped to economically link a border region, which in the 1970s and

'80s was just a military theatre for two Socialist armies ready to repel each other's possible aggression. But it left some scars and created fears in Moscow, which would later influence the decision-making process.

Arms transfers also took off in the 1990s as the military industries of former rivals entered into a stage of mutual dependence. After the West imposed an arms embargo on China after the Tiananmen Square massacre, Russia (and to a lesser extent Ukraine) became a critical source of sophisticated weapons. For Russia, which had lost its main customer after the collapse of the Soviet Union, the partnership was also of utmost importance. In the 1990s, Chinese orders helped troubled military plants to survive. The share of Chinese contracts in the revenues of the Russian defence industry in the 1990s was never less than 30 percent and in some years exceeded 50 percent. But in the 2000s, Russian arms started to face increasing competition from Chinese manufacturers on the domestic market and Moscow became worried about the Chinese habit of copying Russian equipment such as the Su-27 jet fighter. Russian policymakers also became increasingly nervous about selling their most sophisticated and advanced weapons to the growing Chinese military. The last large orders were placed in 2007.

Nevertheless, relations remained good after Vladimir Putin and Hu Jintao took over, and in 2001 the two countries signed a Treaty of Friendship. More importantly, they also managed to solve the territorial dispute after Russia ceded to China 337 km<sup>2</sup> of disputed lands in exchange for Beijing's removal of other claims. Both countries embarked on a project to transform the loose "Shanghai Five" format into a real regional integration format – the Shanghai Cooperation Organisation. Driven by authoritarianism and anti-Americanism, Moscow and Beijing increased their level of political cooperation on international issues as well: both opposed the wars in Afghanistan and Iraq, voiced concerns about the US military presence in Central Asia, and joined forces in the UN Security Council to defend countries such as Iran, Myanmar, Sudan, and Zimbabwe.

By 2008, trade had increased to \$55.9 billion, with an average growth rate of 37 percent between 2002 and 2008. However, Russia was increasingly alarmed by Beijing's perceived plan to increase its economic footprint in Russia and turn the country (especially Siberia and the Far East) into the "resource subsidiary" of "China Inc." Informal limitations were put on all Chinese investments in sensitive sectors such as energy, mining, and infrastructure. Chinese businesspeople were quietly pushed back from the Far East, especially the Primorye border region.

Progress on energy cooperation was also slow. China, which had been increasingly focused on energy security since becoming a net importer of energy in 1994, wanted to construct a cross-border oil pipeline from eastern Siberia, which could provide the country with a source of secure oil if the US cut off Chinese supplies from the Middle East and Africa in the case of a maritime conflict (Chinese thinking on energy security was always informed by the Japanese experience during World War II). But Moscow had little interest in the project. Yukos, the largest Russian

oil company, began talks in 2001 which broke down after Mikhail Khodorkovsky, then the majority stakeholder, was imprisoned. Rosneft inherited the idea of a pipeline to China, but a deal was never signed.

Russia was similarly slow on gas contracts. For Gazprom, the Chinese gas market was not attractive: small volumes (gas contributed about 2.5 percent to China's energy mix), low prices, and state regulation. Lack of good expertise and fact-based projections made Gazprom miss the opportunity to enter the market in the 2000s. In 2006, Putin visited Beijing and announced ambitious plans to construct two gas pipelines – a western route from Western Siberia through the Altai mountains, providing 30 bcm a year and an eastern route from the Kovykta and Chayanda fields from Eastern Siberia providing 38 bcm a year – to be completed by 2012. But the idea of an “energy alliance” was meant mainly to send a strong message to European customers after the Russian-Ukrainian gas war in 2006. After European customers signed new contracts with Gazprom, the plan was informally dropped. In frustration, China turned instead to Turkmenistan. At the time, Moscow was concerned only about its dominant position in the EU market. As long as the China-Central Asia gas pipeline (the first line was launched in 2009) was removing potential volumes of Turkmen gas from the EU-backed Nabucco project, Russia was happy.

Thus, under the Putin's first two terms as president, the relationship with China was driven by Russia's relations with the West. “Relations with us had no real value for the Russians,” a Chinese interlocutor said. “They used us only as a threat to the EU. Europe – that is what they really cared about.”<sup>1</sup> Meanwhile, Beijing was fully engaged in diversifying its sources of supply for oil and gas and other commodities. Russia's preoccupation with the EU gave it a free ride in Central Asia, where China was shopping for energy, mining, and infrastructure projects.

However, after the global economic downturn in 2008–2009, Moscow experienced three economic shocks: low oil prices translated into lower budget revenues, falling share prices combined with liquidity problems in Western capital markets, and weakening domestic demand. State-owned and private companies needed new sources of capital – and turned to China. In the autumn of 2009, Rosneft and the state-owned oil-pipeline monopoly Transneft borrowed \$25 billion from the China Development Bank (CDB) in a “loan-for-energy” scheme, with a promise to deliver 15 million tons of oil a year for 2011–2015 as collateral. The contract included the construction of a land-based pipeline and another from East Siberia to the Pacific Ocean.

By the end of 2009, China was Russia's biggest trading partner, second only to the EU as a whole – a place it continues to hold. More importantly for Russian decision-makers, Russia's GDP fell about 9 percent while China's GDP grew 8.7 percent. One Russian official says: “This time the leadership got the message: we need to be serious about Asia.” After 2009, Russian state-owned financial institutions

such as Vnesheconombank and VTB ran to Beijing for cheap loans, and the largest aluminium producer, Rusal, launched the first Russian IPO on the Hong Kong Stock Exchange (HKEx). Other milestones include the creation of a joint investment fund, a joint venture between China Investment Corporation and the Russian Direct Investment Fund and the signing of an ambitious programme of regional cooperation between the Far East and China's north east by Hu and Medvedev in 2009.

Nevertheless, there were still unofficial limits for Chinese companies, which, for example, were not allowed to buy into oil and gas deposits regarded as “strategic” by the Russian government. The Russian authorities also opposed Chinese participation in large infrastructure projects and the presence in Russia of Chinese carmakers. As the economy slowed – in 2013, GDP growth was 1.3 percent despite the optimistic government target of 5 percent at the beginning of the year – Russian companies began increasingly to look east. But it was only with the start of the Ukraine crisis and the first round of sanctions that Moscow's attitude changed dramatically. The “pivot to Asia” that Putin announced in 2012 in his speech to the National Assembly, when Russia held the presidency of the Asia-Pacific Economic Cooperation (APEC), was turning into a “pivot to China”.

### **Russia's pivot to China**

After the Ukraine crisis began, the Russian government immediately started to assess the economic implications. In a series of study sessions in the Kremlin and in the government building on Krasnopresnenskaya Embankment in the spring of 2014, experts went through the sanctions regimes applied by the West in recent years, including Iran and North Korea, and immediately spotted Russia's three weakest points: critical dependence on the European energy market, critical dependence on Western capital markets, and critical dependence on important technologies including offshore drilling, LNG plants, or telecommunications (discussions on telecoms equipment had started a year earlier, after the Edward Snowden revelations, but nothing had been done). They concluded that if the West imposed sanctions, Russia would have no other choice than to be more and more accommodating to China – even if it turned Moscow into the junior partner in the relationship.

At the same time, the Chinese Communist Party Politburo Foreign Affairs Leading Small Group held a series of seminars, some of them headed by General Secretary Xi Jinping. The Chinese foreign policy elite concluded that though the crisis in Ukraine may have some negative implications for Chinese interests (Crimean annexation and Russian rhetoric on national self-determination were seen as particular threats for complicated situations such as Taiwan and Xinjiang), the opportunities outweighed the risks. As Russia would be looking to diversify from the West, the only major partner in Asia for them would be China. In geopolitical terms, the crisis was also seen as beneficial because it would distract the US, which would pay less attention to Chinese moves in Asia-Pacific, particularly the

<sup>1</sup> Unless stated otherwise, quotes are from several sets of interviews conducted in Moscow from June 2014 to January 2015, in Beijing in October and December 2014, and in Hong Kong in October 2014 and January 2015.



South China Sea. "This conflict will give us an additional 10 years of breathing space", as one of the Chinese experts involved in framing Beijing's response puts it.

The formation of the new type of relationship proceeded fast. In May 2014, Putin visited Shanghai to attend the Conference on Interaction and Confidence Building Measures in Asia and signed 46 documents. In October, Prime Minister Li Keqiang visited Moscow and signed 38 agreements. In November, Putin attended the APEC summit in Beijing and signed an additional 17 agreements. Though the agenda for these summits was put together in a rush and was meant to impress the outside world – Russian and Chinese officials admit that some documents were so unprepared that in normal circumstances they wouldn't reach the leaders' desktops – they were very important. Russian and Chinese interlocutors point to three strategic spheres: energy, finance, and infrastructure and technology.

### *Energy*

Long before the Ukraine crisis, energy was a crucial part of the Russia–China relationship. Earnings from selling hydrocarbons on international markets accounted for 70 percent of budget incomes in Russia. At the same time, since becoming a net importer of oil in 1994, China has been busy securing access to new sources of supply needed for economic growth. Recent developments include the first purchase of a stake in the Russian oilfield Vankor by China National Petroleum Corporation (CNPC) (a deal with Rosneft was signed in November 2014); plans for the Chinese companies Sanxia, the Yangtze power group, and State Grid Corporation to build electricity-producing plants in Eastern Siberia and the Far East; and joint plans to increase coal deliveries to China. But none of these projects is as important as the new mode of cooperation in the gas sphere.

A long-awaited gas deal was signed when Putin visited Shanghai in May. Gazprom and CNPC signed a contract on selling gas from two Eastern Siberian gas fields, Kovykta and Chayanda, to China. The gas will be delivered via a new pipeline called Sila Sibiri ("The power of Siberia"), which will pump 38 bcm annually till 2030. The parties did not disclose the price, but they named the overall figure for the contract: \$400 billion (people familiar with details say the price is around \$385 per tcm). Those involved in the negotiations admit that the political pressure from both Putin and Xi was an important factor in sealing the contract. But the conditions were also favourable: the price was the only unresolved issue, since all other major parameters of the contract (including take-or-pay levels) had been agreed in 2010. One of the Chinese negotiators said: "We could, of course, press Russians and get the lower price, but we didn't. We need to build a long-term partnership. The gas is cheaper than LNG and we have money to pay."

The reason why the profit margin on the contract is very low and may even be unprofitable is the cost of infrastructure. According to Gazprom, building the pipeline and developing Kovykta and Chayanda will cost Russia

about \$55 billion. To support the company, Putin promised to introduce favourable tax regimes. This is normal given that the infrastructure built for this contract may serve for the next deal, just as pipelines for the Soviet-German gas deal commissioned in the 1960s help Gazprom to extract large revenues from the European market now. According to several sources, China offered to help building the Sila Sibiri pipeline, which could reduce the price by 30 percent. A Chinese banker involved in the negotiations said China could build the pipeline "cheaper, more reliably and on time" and even offered to provide an advance payment, but the Russians refused. The reason why Gazprom wanted to build the pipeline itself is obvious: such large projects are a major source for income for companies with close ties to the monopoly and the Kremlin.

However, the fall in global oil prices at the end of 2014 may significantly change the terms of agreement and make the deal even more profitable for Beijing. The price in the May contract was calculated using a complicated formula, in which the price of crude in international markets plays a significant role. The Russian and Chinese negotiators have not revealed how the falling oil price has affected the contract and its profitability for Gazprom, but several sources on the Russian side envisage that if the price remains low for a significant period of time, Gazprom will have no other option but to submit to the Chinese demand and let Beijing build the pipeline.

The low oil price may also affect other energy deals. During Putin's visit to Beijing in November, Gazprom and CNPC signed a framework agreement on the second pipeline envisaged in the 2006 memorandum. The project will include building a pipeline with 30 bcm per year capacity from Western Siberian gas fields – the same resource base used for Gazprom's contracts with European customers. As the fields are already developed and some parts of existing pipeline infrastructure can be used, this western route could be operational even before the eastern route, according to Gazprom's chief executive Alexey Miller. The major question is the price. Moscow wants the price it gets in Europe or the same as the eastern route (\$360–385); Beijing wants the price it pays for Turkmen gas coming through the Central Asia pipeline (\$200–260).

The third gas project which is now under discussion is a pipeline from Vladivostok to north-eastern China. In 2012, Gazprom commissioned an 8 bcm per year pipeline linking the gas-producing island of Sakhalin to Vladivostok, where it wanted to build an LNG plant. But Gazprom may now change its mind because it can't secure loans for plant construction due to Western sanctions and the management doubts that the company will get access to required foreign technology (during the last 10 years when oil prices were high, Gazprom built just one LNG plant using Shell technology). Now, according to Gazprom's Miller, the company is looking into the possibility of abandoning the LNG plant project and building a pipeline to China instead.<sup>2</sup>

<sup>2</sup> "Gazprom to cancel Vladivostok LNG project", Vedomosti, 13 October 2014, available at <http://www.vedomosti.ru/companies/news/34612841/vybor-gazproma>.

Although the Ukrainian crisis has prompted Moscow to start diversifying its gas exports and entering the Asian gas market, the major challenge it faces is that, with sanctions and low oil prices, it is forced to choose land-based pipeline options that link Russian gas to one customer without flexibility. The danger for Russia is that, in the future, China may change the conditions of agreements with it. A precedent was set in 2011 when CNPC refused to pay the full price for oil delivered via the Skovorodino-Mohe pipeline and demanded a discount of \$15 a barrel. The Russian side was fortunate that, given the turmoil caused by the Arab Awakening, China decided not to disrupt its relationship with one of the suppliers and agreed to just a \$1.5 per barrel discount.

It should also be noted that China cannot replace European energy markets in the short or even medium term. Currently, Gazprom sells about 150 bcm annually to Europe, compared to just 1 bcm to China. If all the planned projects are built, Gazprom could sell 76 bcm per year to China but at a lower price. At the same time, Russia's lack of other options presents a great opportunity for China. Though supply from Russia is not critical in terms of volume, it is important to China in terms of security and as a bargaining factor in talks with other oil and gas suppliers. Access to Russian gas may also speed up the transfer to more environmentally-friendly power generation, with more extensive use of gas in big cities. This is important for domestic stability as pollution is becoming a more important political issue.

### *Finance*

Whereas the energy partnership with China is a long-term project, financing is a more pressing issue for Russian companies. The introduction of sectoral sanctions in July 2014 restricted access to Western capital markets for some key Russian state-owned financial institutions, which led Western financial institutions to re-evaluate the country risk for Russian borrowers and deny further credits for all Russia-registered entities. As a result, Russian companies were isolated from the financial centres in London and New York, which used to be destinations of choice. Thus tapping alternative sources of capital became a necessity.

In May 2014, a high-level Russian official delegation including First Deputy Prime Minister Igor Shuvalov visited China to discuss the possible replacement of Western credits by Chinese financial institutions. The Chinese negotiation team, headed by Vice Premier Zhang Gaoli, promised Beijing's support and talked about increasing the role of national currencies in bilateral trade in order to decrease dependency on the euro and the dollar, increasing loans from Chinese state-owned banks to Russian companies, listing Russian debt and equity in Hong Kong, and opening the Shanghai Stock Exchange to foreign companies.

Since this visit, several important developments have shown the potential for financial cooperation between Moscow and Beijing – but also its limits. The most important issue was the possible use of national currencies in bilateral transactions between China and Russia. During Li Keqiang's visit to Moscow in October 2014, the Central Bank of Russia

and the People's Bank of China signed a three-year currency swap agreement for RMB 150 billion (about \$24.5 billion) – the twentieth agreement of its kind for China, which uses currency swaps with major trade partners to promote the renminbi globally, and the first of its kind with Russia. In September, Deputy Finance Minister Alexey Moiseev stated that China and Russia aim to transfer up to 50 percent of their trade to national currencies.<sup>3</sup>

The logic is not only political. Deals in national currencies can lead to benefits of up to 5–7 percent for buyers of Chinese products by avoiding currency conversion and hedging against foreign exchange risk. However, the non-convertibility of the renminbi is a major barrier. In 2013, ruble-renminbi settlement accounted for just 2 percent of bilateral trade. It is also significant that Russian companies that transferred part of their cash from dollars and euros after rumours that their accounts in Western currencies could be blocked as part of next sanctions package bought convertible Hong Kong dollars (pegged to the US dollar) rather than renminbi.

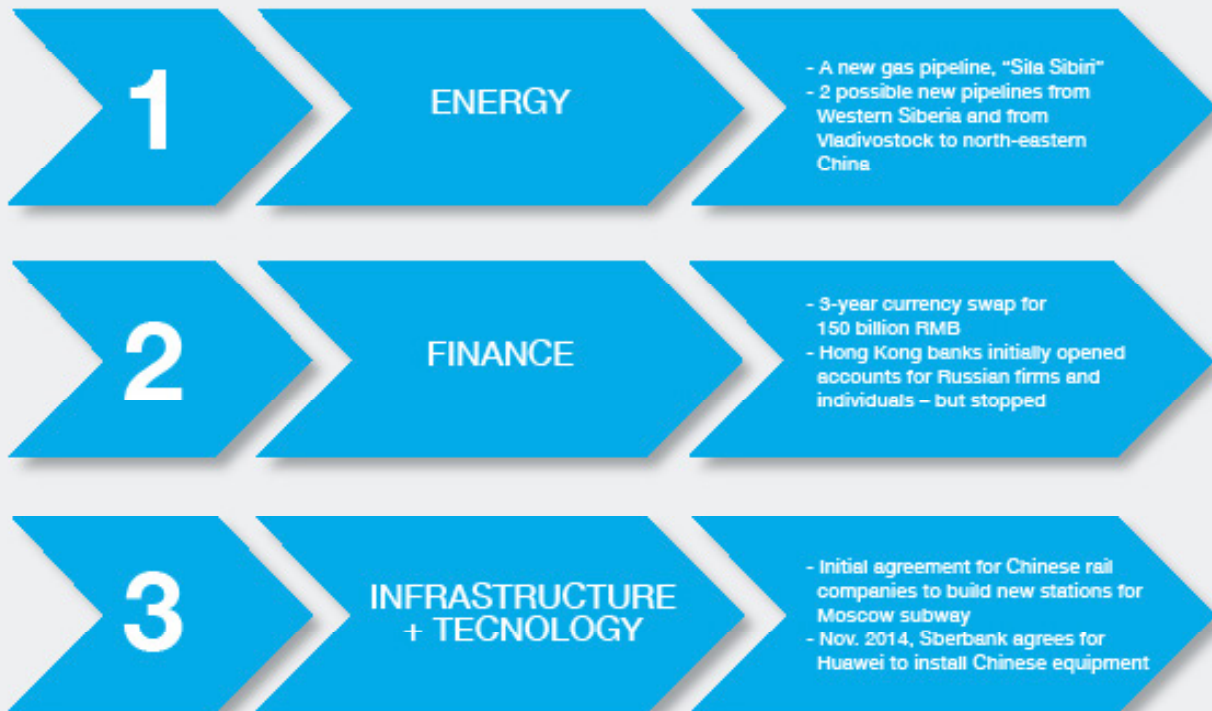
It would be a game changer if Beijing and Russia started to trade major items such as oil and gas in their national currencies. In an interview in November, Putin hinted that this is already being discussed.<sup>4</sup> According to him, China wanted to buy oil from the Vankor field in renminbi, which Rosneft could later use for buying Chinese drilling equipment. One of the remaining issues, according to Russian interlocutors, is the exchange rate the Chinese side will use: will it be the “onshore” rate or the “offshore” rate used for trade settlement through Hong Kong. Once these issues are sorted out, one may expect a dramatic increase in the use of national currencies in China–Russia trade. For Moscow, this will help to lower the risk of being overly exposed to the euro and the dollar. For Beijing, it will be just another major step in promoting its currency before turning to full convertibility.

Although China has made some progress in diversifying away from dollars and euros during the last six months, it has proven more difficult to replace London and New York with Hong Kong and Shanghai. Foreign companies are still unable to list their shares or issue bonds in Shanghai. In May, China hinted that once the stock exchange was open for foreigners, Russian companies might get some “preferential treatment” and that Chinese state-owned banks and funds would invest in Russian paper. But this move, even if it happens, is some way off. HKEx has long been open to foreign companies and has hosted some Russian listings, including the landmark initial public offering in 2010 of Rusal. Although the announcement by Russian state-owned banks VEB and Sberbank that they planned to buy up to 70 percent of the issue led to concerns about hosting a “political IPO” of a troubled company, the listing proceeded. But many funds that invested in Rusal have lost money and private investors in Hong Kong are now sceptical about investing in Russian companies. Following pressure by the US Treasury, Hong Kong banks have stopped opening bank accounts for Russian firms and individuals.

<sup>3</sup> “Ministry of Finance: Russia and China could transfer half of their trade into national currencies”, TASS, 9 September 2014, available at <http://itar-tass.com/ekonomika/1430158>.

<sup>4</sup> “An interview to the information agency TASS”, President of Russia official website, 14 November 2014, available at <http://kremlin.ru/news/47009>.

## THREE STRATEGIC SHIFTS IN COOPERATION



As for the possible loans from Chinese state-owned banks, three things need to be taken into account. First, Chinese banks are arms of Beijing – so their natural habit is to provide loans to Chinese state-owned enterprises (SOEs), not to foreign companies. If banks like CDB give foreign companies access to credit, a project with Chinese interests is always implied. Second, after Xi launched his anti-corruption campaign in 2013, many top managers of Chinese financial institutions were imprisoned. This resulted in the reluctance of the new managers to sign any new loans for foreign companies. Third, banks have become more conservative in their transactions since the Chinese Communist Party Central Committee's Third Plenum in November 2013, which required Chinese SOEs, including banks, to be more efficient in their use of capital.

Thus, in the short term, China cannot become a real alternative for Russia to replace the West as a source of capital. But in the medium term, and especially in the long term, if European and American sanctions remain in place, Russian companies may increasingly tap into opportunities provided by China. For Beijing, Russia's decoupling from Western financial markets provides a chance to strike deals on Chinese terms and also to turn Russia into a testing-ground for some financial experiments needed for opening up its own financial system.

### *Infrastructure and technology*

The last area of the Russia–China relationship where major shifts have occurred since the Ukraine crisis is cooperation in infrastructure and technology. For the last 15 years there was an informal ban on Chinese participation in bids on large infrastructure projects in Russia. Moscow's concerns included increased competition for local companies (some with good ties to the Kremlin) and a possible influx of Chinese migrant workers. In May 2014, this ban was lifted. The Chinese Railway Construction Corporation (CRCC) has expressed interest in constructing new stations for the Moscow subway system (the city government signed a memorandum of understanding with CRCC, though it may not be fulfilled due to ruble devaluation). CRCC may also participate in constructing a high-speed railway line – Russia's first – from Moscow to Kazan.

With limitations put on technology transfer from the EU and the US (and Western companies considering Russia to be risky), Russia may increasingly turn to China for technology. It cannot hope to substitute many critical technologies (most notably in offshore drilling), but some are available in China for a reasonable price. The area in which the Russians show most interest is telecommunications equipment. Discussions on shifting Russian networks used by government bodies from US-produced to Chinese-produced equipment intensified in 2013 after Edward Snowden's



disclosures about surveillance by the US National Security Agency. In May 2014, a task force was established under the Russian telecommunications ministry to study possible replacement. “We may be replacing American bugs with Chinese bugs”, says an official involved in the study. “But at least the Chinese are our partners.” In November 2014, Sberbank was the first major non-telecoms company to sign an agreement with Huawei to install Chinese equipment.

Technological cooperation is particularly sensitive in the military sector. For the last 10 years, there was an informal ban on selling the Chinese the most advanced technologies. Moscow’s concern was in part that the weapons could one day be used against Russia in a border conflict, but also in part that the Chinese could produce copies of Russian equipment and compete with them in markets such as Myanmar or Egypt. For example, while China wanted to buy only a limited number of Su-35 fighter jets from Russia, Moscow wanted China to buy a large number as advanced compensation for future copying. However, some in Moscow now want unlimited cooperation with China in the military-industrial area. According to a Russian expert with close ties to the military, Russia would even now be quickly defeated in a conventional border conflict with China, so it will in any case have to rely on its nuclear deterrent. Chinese experts see cooperation with Russia as crucial to military modernisation. “We can afford to buy large parties of weapons to accommodate Russian concerns”, a Chinese military expert says.

### **A soft alliance**

While Russia’s pivot to China is focused on the economy and fuelled by the Kremlin’s desire to find alternative markets and sources of capital, politics is also important. Even before the Ukrainian crisis, Beijing and Moscow supported non-democratic regimes around the world, opposed the US presence in Central Asia, held joint military exercises, and tried to craft a joint strategy to counter the “colour revolutions”. The current situation will only reinforce this mood. Chinese officials see Russia as more accommodating to some of Beijing’s ideas about global and regional governance. “It is not only because the conflict in Ukraine drives our countries closer, but because the Kremlin became more anti-Western on an emotional level”, a Chinese expert with ties to Zhongnanhai says.

Moscow and Beijing will likely stop short of a formal military alliance. The last thing Russia wants is to get dragged into territorial conflicts between China and its neighbours in the East or South China Sea. Meanwhile, the Chinese also see the Kremlin as easily provoked into an unnecessary conflict of which Beijing doesn’t want to be a part. This line partly explains China’s stand on Ukraine: it did not criticise Russia openly for annexing Crimea and destabilising Donbas, but it also did not support Moscow’s line. But China and Russia may form a kind of “soft alliance”. In particular, political cooperation may be expanded in three areas: cooperation in Central Asia; alternatives to the Bretton Woods institutions; and increased cooperation on domestic political issues.

### *Cooperation in Central Asia*

Before the Ukraine crisis, Moscow was ambivalent about Beijing’s expansion in Central Asia. On the one hand, the Kremlin was happy with Beijing’s quest for cheap gas as long as it helped Gazprom to protect its stake in the European market. Moscow and Beijing also joined forces in opposing US military presence in the region after the beginning of the Afghan campaign, and helped remove US bases from Uzbekistan and Kyrgyzstan. On the other hand, Moscow was worried about former Soviet republics becoming more dependent on Beijing than on Moscow and quietly torpedoed Chinese proposals to integrate the region economically. For example, it did not support the Chinese idea of creating a joint bank of development for the Shanghai Cooperation Organisation (SCO) headquartered in Beijing and financed with Chinese money, or projects to connect Europe to Western China through Central Asia.

Now, however, Moscow is ready to accept Beijing’s new role as a major economic power in Central Asia and hopes it can tap into financial resources provided for Central Asian development. Russia may finally support the creation of an SCO development bank with registered capital of \$10 billion. Putin also agreed to give the Silk Road Economic Belt – Xi’s foreign-policy priority since 2013 – the green light after Xi agreed to include Trans-Siberian and BAM railways in the scheme. Moscow now hopes to maintain its role in Central Asia not as the biggest external economic power but as a security provider through the Collective Security Treaty Organization and through economic integration through its Eurasian Economic Union.

### *Alternatives to the Bretton Woods institutions*

Russia will be willing to support different Chinese-led financial institutions, which are meant to be a long-term response to the unfair representation of the emerging economies in the Bretton Woods institutions such as the International Monetary Fund or the World Bank. In 2014, Moscow supported the creation of a development bank under BRICS on Chinese terms – a project it opposed just a year ago. Moscow didn’t manage to become the founding partner of the China-led Asian Infrastructure Investment Bank, which was announced in October 2014, but may join it in 2015.

### *Domestic political issues*

As non-democratic states, China and Russia have a lot in common. The Chinese version of authoritarian rule is more efficient, and as Beijing is betting on preserving the current regime in Russia, it may be willing to share some tools for more efficient control over the population. The first realm for cooperation will be the internet, which both Beijing and Moscow see as a possible tool for empowering their domestic opponents – especially after the Arab Spring, in which social media played a role. New laws introduced by the Russian State Duma on controlling the internet and building a new model of relationship between

providers and customers were all based on the Chinese experience. In November 2014, Moscow and Beijing were planning to sign a framework agreement on cooperation in cybersecurity. The ceremony was postponed to next year as the two sides demonstrated an interest in going even deeper and forming a real cybersecurity alliance.

As a result of the Ukraine crisis, the relationship between Russia and China will become stronger and more comprehensive. For Russia, China cannot fully replace the West as a market and source of capital and technologies, but cooperation can help to reduce the damage caused by sanctions. Russia's economy will be in a worse shape, but China may provide it with the minimum level of wealth needed for Putin's regime to stay in place. For China, meanwhile, the crisis provided a great opportunity for Beijing to turn Russia into a junior partner in the relationship and secure many of its strategic interests. A submissive Russia will give China more resources to prepare itself for the ultimate struggle for great-power status in Asia-Pacific. Russia may become a space for Chinese "pilot schemes" to test the global governance models (most notably in finance) that Beijing wants to promote. At the same time, the Chinese will try to avoid making it apparent to Russia that it is a junior partner and present the relationship as a "friendship of equals".

However, there will still be several challenges for the relationship. For Russia, a pressing challenge will be building expertise on China. During the Soviet era, Russia had some of the best China-watchers in the world, but the new Russian elite is largely illiterate about Asia in general and China in particular. Russia will also need to manage the Chinese workforce, which may be a condition for Beijing's participation in large infrastructure projects and could lead to a nationalistic backlash. Perhaps most importantly, Russia will need to balance its growing dependence on China with relationships with other Asia countries. Since the most natural partners, Japan and South Korea, are US treaty allies, Russia may have to concentrate on other Asian countries such as India and Vietnam. But increased cooperation with these countries, especially arms sales, could in turn increase tensions between Moscow and Beijing.

There will also be some challenges for China. Above all, it will need to secure its interests in Russia while maintaining a co-operative relationship with the US. Some Chinese experts suggest that Beijing should try to position itself as a middleman between the Kremlin and the West. Chinese corporate executives worry about the introduction of US sanctions against companies from third countries that do business with sanctioned Russian entities. Chinese experts also worry about alienating the Russian elite. According to one of the advisors close to the Politburo Leading Small Group on foreign policy, Xi sent a strong message to corporate executives and officials to think long-term and avoid pushing Russians too hard in negotiations. As a Chinese interlocutor put it: "It is stupid to kill the sheep which can give you wool and breed lambs in order to get a short-term profit."

## Two options for the EU

The relationship between China and Russia will have implications for Europe on several levels. Most immediately, it could undermine the effect of EU sanctions against Russia. Chinese support could help keep the current Russian regime in power and allow it to keep destabilising eastern Ukraine. Unable to maintain legitimacy through economic growth, Putin may borrow Chinese practices of authoritarian control over the population and dismantle the last achievements of the democratic period in the 1990s. Meanwhile, armed with Russian technology and Russian resources, China could become even more assertive in its neighbourhood. With US leadership in the region being in question, this may lead to an arms race, with unpredictable consequences for regional and global security.

There are some short-term and long-term economic implications as well. In Russia, European companies may lose opportunities even in sectors that are not part of the sanctions (high-speed rail, where Siemens used to be a contender, is a good example). In the medium term, Russia may reorient itself to Chinese technologies in many areas that used to be dominated by European producers. On the other hand, through partnership with Russia, China may get either some technologies, or some boost in fundamental research that in the medium term will make Chinese manufacturing more innovative and globally competitive. A closer relationship between China and Russia could even undermine the liberal international order, of which Europe has been a founding member, and lead to an increased fragmentation of the global economy.

In terms of how to respond, the EU has two options. Together with the US, it could seek to isolate Russia further by dissuading China from co-operating with Russia by introducing sanctions against Chinese (and other any third-country) companies that do business with sanctioned Russian entities (that is, the military-industrial complex, oil and gas firms, and state-owned banks). This option would resemble the way that the EU and the US handled the Iranian nuclear issue. However, this approach would be risky. Chinese companies might not comply as they did in the case of Iran; sanctions could create a major rift in EU relations with China and other foreign partners, including some possible legal action through WTO mechanisms; and it could lead to a faster than anticipated implosion of Putin's regime, with unpredictable consequences for Russia and regional security order.

The second option is aimed at giving Russia an alternative to China. If the EU is unable to lift sanctions, and does not want to see the transformation of Russia into Beijing's junior partner, it could work with the US to allow Japan and South Korea not to uphold the sanctions regime against Russia and provide it with alternative sources of capital and markets in East Asia. Although this option might create some loopholes in the sanctions regime and therefore reduce their impact – and thus make Russia less likely to moderate its behaviour in Ukraine – it could help



the EU to maintain its principles while being pragmatic in regard to its long-term interests. This option could also be attractive to the US, which will not want to strengthen China in Asia-Pacific through partnership with Russia.

Putting aside the question of how effective the sanctions are – they were successful in undermining the Russian economy but did not stop the Kremlin’s support for the separatists in Donbas, as the January 2015 offensive has shown – this option will address the long-term challenges presented by a closer Russia-China link. The longer Russia is forced to orient itself towards China, the more important the consequences will be. Some key elements such as arms deals and Chinese control over key resource deposits may become irreversible and have a lasting effect on Russia, European interests, and global security – even after Putin has left office.

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