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On the cover: China’s president Xi Jinping (left) and Russia’s president Vladimir Putin ahead of a group photo ceremony at the Fourth Summit of Conference on Interaction and Confidence Building Measures in Asia. © ITAR-TASS/ Mikhail Metzel/Corbis.
Ukraine, Russia, and the China Option
The Geostrategic Risks Facing Western Policy

Europe Policy Paper
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By Andrew Small

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1 Andrew Small is a Transatlantic Fellow with GMF’s Asia Program based in Washington, DC. He is the author of The China-Pakistan Axis: Asia’s New Geopolitics, forthcoming with Hurst/Oxford University Press, 2014.
**Executive Summary**

**The Issue**

Beijing has sought to take a neutral stance in the stand-off between Russia and the West. Yet as the recent $400 billion Sino-Russian energy deal illustrates, China's economic decisions will inevitably have major implications. The question is not whether Beijing will tilt definitively toward one or other party but the extent to which China will prove to be an enabling or a constraining factor for different facets of Western and Russian policy. In a crisis that has hinged to an unusual degree on trade deals, loans, energy exports, financial assets, and sanctions, the world's second largest economy cannot avoid becoming politically embroiled.

**Policy Recommendations**

In some areas, there are opportunities for the European Union, in cooperation with the United States, to leverage China's growing geo-economic interest in Central and Eastern Europe, where Beijing and Moscow's interests are far from identical. But the principal challenge will be navigating China's role in mitigating the impact of Western sanctions on Russia. At present there is the risk that the EU and the United States will end up with the worst of all worlds: sanctions that are not strong enough to change Moscow’s behavior or to deter China from further military assertiveness in its own neighborhood, yet just potent enough to push Russia into a closer relationship with China, and to persuade Beijing that it needs to immunize itself against exposure to the Western financial system.
Within the space of two months, three presidential visits marked a defining period for China’s relationship with the West: Xi Jinping in Europe, Barack Obama in Asia, and Vladimir Putin in China. Hanging over all of them has been the crisis in Ukraine. Much of the best recent commentary has focused on pronouncing China the “winner,” explaining why Beijing will refuse to choose between Russia and the West, or arguing that a China-Russia axis is unlikely to ensue.

Yet despite the supposedly pervasive mistrust between Moscow and Beijing, Putin’s visit to China at the end of May saw the conclusion of major economic deals, which, coupled with the relaxation of restrictions on Chinese investment and Russian arms sales, has significant implications both for Russia’s scope to weather the West’s economic squeeze and for Chinese military capabilities. Emphasis on the unlikelihood of a Sino-Russian alliance underestimates just how much mutual support the two sides can give each other without any deeper political or security alignment.

China’s economic presence will also weigh increasingly in Europe’s eastern neighborhood. This has already been evident in Ukraine itself, whether it be former President Viktor Yanukovych flying to Beijing to seek a top-up for Kyiv’s $10 billion of Chinese credit just days after walking away from the EU association agreement, or Russia’s touting of Chinese investments in Crimea as providing de facto legitimacy for its annexation. But China has certainly not signed up to facilitate the perpetuation of Moscow’s economic and political dominance, and has shown few qualms about systematically displacing Russian economic influence in other parts of the former Soviet Union. As China’s geo-economic strategy accords an increasingly important role to a region that now finds itself as a vital link in the “Silk Road Economic Belt” — a wide-ranging set of plans to develop Eurasian infrastructure, energy, and commercial connections between China’s Western provinces and European markets — Chinese investment, financing, and trade is a potential asset for the West in undermining Moscow’s efforts to keep Central and Eastern Europe under its thumb (see Figure 1).

An issue with even wider implications is Beijing’s reaction to the first use of sophisticated financial sanctions against a large, globally integrated economy and fellow P5 member rather than a classic “rogue” state. U.S. officials have warned in barely-veiled terms that these measures could be replicated if China were to mirror Russia’s behavior in its own neighborhood. In principle, this might be expected to act as a deterrent for

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Chinese policymakers, who are less prone than their Russian counterparts to affecting nonchalance about the repercussions of becoming embroiled in economic warfare. But over the longer term, there is the risk that the West’s financial sanctions could hasten Chinese efforts to strengthen the resilience of the non-dollarized financial system. Current debates in Russia about expanding the issuance of yuan-denominated bonds and the use of the Chinese payment network, UnionPay, in place of sanctions-hit Visa and Mastercard appear to be small fry given the scale of capital flight from the Russian economy. But they are a foretaste of what a more sustained such push would look like. As Barry Eichengreen notes, the dollar moved from a “negligible role in international trade and payments” to surpass sterling as the leading international reserve currency in just ten years.9

Like the United States in 1914, when the dollar’s internationalization first accelerated, China in 2014 has become the world’s largest trading nation, and Beijing certainly has the wherewithal to develop a robust alternative to the Western-dominated banking and financial transaction networks, parts of which it now has greater cause to fear might be weaponized against China.

Counting Crimea’s Costs for China

In the early phase of the crisis, China studiously avoided any perception of a tilt toward either Russia or the West, whether through its UN abstentions or a series of opaque official pronouncements. The Chinese foreign ministry’s insistence on repeating cryptically that “there are reasons that the Ukrainian situation is what it is today” was only topped by Xi’s own elliptical statement that the situation “seems to be accidental but has the elements of the inevitable.”10 A more frank summary from an advisor to the Chinese government was that “we’re going to lie low on this

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issue, wait and see how it plays out, and at the end we'll be friends with everybody.”

The Ukraine crisis certainly appears to afford Beijing a number of advantages. It finds itself being courted by Moscow, Washington, and European capitals. There is the prospect that the United States will be distracted yet again from its Asia pivot. The EU debates over plans to reduce its dependency on Russian gas came at just the moment when China’s own long-running negotiations with Gazprom reached a decisive stage. Yet the view that Beijing emerges as a comfortable winner from the crisis in Ukraine, and can simply choose not to choose sides while reaping benefits in its relations with all of them, does not capture the full picture.

As nervous U.S. allies in Asia have raised a steady drumbeat of concerns that Russian success could embolden China, Beijing has struggled to escape the taint of Putin’s actions. The Japanese Prime Minister was one of the first off the mark, noting at the March G7 meeting in the Hague that “[w]hat’s happening in Crimea isn’t merely an issue for this region, but it could happen in Asia.” Senior U.S. policymakers made the link as well, with the State Department’s top Asia official stating, during his congressional testimony on the South China Sea, that the retaliatory sanctions imposed on Russia should have a “chilling effect on anyone in China who might contemplate the Crimea annexation as a model.”

Ahead of Obama’s Asia visit, U.S. officials briefed the press that the U.S. military had “prepared options for a muscular response to any future Chinese provocations in the South and East China seas, ranging from displays of B-2 bomber flights near China to aircraft-carrier exercises near its coastal waters,” a menu of options that “reflects concerns that U.S. allies in Asia have about the Obama administration’s commitments to its security obligations, particularly after Russia’s seizure of the Crimean peninsula.”

Evidently there were already anxieties in the region about how much appetite the United States had to defend friends and allies under threat, but Ukraine has further raised the stakes. With the “Putinization” of the debate about great power behavior, China now faces an even more exacting level of scrutiny. An assortment of China’s techniques — expanding sovereignty claims, economic coercion, the use of non-military actors to provoke confrontations, salami-slicing tactics — take on a different resonance in the context of the Eurasian Union, self-defense units, and “Novorossiya.” And while many of these analogies are unfair, in private conversations in Western and

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Asian capitals, they are coming thick and fast. The spectacular turnaround in Putin’s polling following his Crimea gambit has prompted consideration of the circumstances in which the temptation for the Chinese Communist Party to galvanize public opinion behind a populist escalation of disputes in Asia might be too great to resist. Beijing may not have sought to instrumentalize overseas Chinese populations, but Western officials have been moved to wonder what degree of public pressure China would come under if there were to be a repeat of the anti-Chinese riots, expulsions, and pogroms that have occurred in parts of Southeast Asia in recent decades.

China could, of course, have drawn the distinction with Russia very clearly by taking a public stance against the first forcible annexation of territory in Europe since the end of World War II. But Beijing is not keeping its head down simply because it wants to reap rewards for its neutrality. It is also deeply uncomfortable with elements of both Western and Russian behavior over the course of the crisis.
Sino-Russian Relations

A Limited Sino-Russian Partnership

China is certainly not a fan of the tactics that Russia has employed in its neighborhood. Sudden referendums, declarations of independence, and small breakaway republics are still the stuff of nightmares for the Chinese leadership as they cast apprehensive glances at Taiwan, Tibet, and Xinjiang. China’s unwillingness formally to legitimize the Crimea annexation echoed its previous refusal to back Russia’s recognition of Abkhazia and South Ossetia in the aftermath of the 2008 Georgia invasion. However, Beijing’s sympathies essentially lie with Russia. Western-inspired popular movements of the Maidan variety spook China far more than any Russian military adventurism, and it shares Moscow’s anxieties about strategic encirclement and its sense of ideological threat. Vladimir Putin’s speech lamenting the “historical injustice” visited on a Russia that had been “incapable of protecting its own interests,” fulminating against Western-led “color revolutions” and “containment,” and demanding “respect”16 reflected the private thoughts of many Chinese leaders. Xi himself has, in the words of one leading Sinologist, spent the first year of his rule demonstrating a “palpable obsession with the demise of the Soviet Union.”17

Echoing Putin’s description of the fall of the USSR as the “greatest geopolitical catastrophe of the century,” Xi gave one of his first speeches as leader urging party officials to learn the lessons of its untimely end: “Finally, all it took was one quiet word from Gorbachev to declare the dissolution of the Soviet Communist Party, and a great party was gone… In the end nobody was a real man, nobody came out to resist.”18

In the eyes of senior Chinese officials, Putin’s bona fide “real man” efforts at resisting the West have elicited a mix of fascination, attraction and horror. For over a decade, he has been a standing counterpoint to China’s more measured, cautious, and weaker collective leadership, tougher, bolder — and more reckless — in his exercise of power. At times of high political anxiety, Chinese leaders have been drawn to Putin’s Russia by a sense of ideological affinity that has even offered the glimmer of hope that the two sides’ strategic differences might be bridged. A decade ago in particular, when the Tulip Revolution in Kyrgyzstan and the Andijan uprising in Uzbekistan seemed to be bringing the “color revolutions” of Ukraine and Georgia disturbingly close to China’s borders, some of Beijing’s geopolitical caution was thrown to the wind. The 2005 China-Russia “Joint Statement on New World Order”19 and subsequent demands from the Sino-Russian-dominated Shanghai Cooperation Organization (SCO) for the United States to set a timetable for the closure of its Central Asian bases, looked distinctly like China dabbling with a defensive political alliance.

Yet like many of his predecessors in the Kremlin, Putin’s moments of strategic boldness have conspicuously failed to take Chinese interests into account. The Georgia invasion was an embarrassing spoiler for the 2008 Olympics, China’s coming out party, and Putin’s post-9/11 decision to give the U.S. military access to the Central Asian bases

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in the first place stunned Beijing. Moreover, the longstanding obstacles to a deeper relationship showed little sign of being overcome. Russia has deep-seated concerns about becoming an energy appendage of the Chinese economy and sliding into junior partner status in the relationship, fears about China’s encroachment in the Russian Far East, and a residual sense that China may yet become a military rival again. As a result, Moscow has been unwilling to sell its most advanced military equipment, close major pipeline deals, or allow significant levels of Chinese investment in the Russian economy. While the two sides forged a close partnership at the UN Security Council, Russia has given little backing to China’s position in East Asia, selling superior arms to China’s rivals India and Vietnam, and playing Beijing and Tokyo off against each other on energy contracts. Even when Chinese leaders have been quietly cheering Putin on for standing up to the West, they have seen little advantage to involving themselves in an overt confrontation that could drag them into a Cold War style contest or put China’s economic relations with its largest trading partners at risk. Despite lively debates among Chinese foreign policy strategists about the potential value of forging a quasi-alliance with Russia against U.S. “hegemony,” geo-economics has generally trumped geopolitics.

For these and other related reasons, the prevailing view among Russia and China analysts has been that the Ukraine crisis is unlikely to catalyze deeper political bonds between Beijing and Moscow.

**A Deepening Sino-Russian Partnership**

However, there is ample evidence that the two sides do not need to enter into a process of closer political and military alignment to have a decisive impact on each other’s interests. With the Russian economy already in recession, hemorrhaging capital (the IMF expects at least $100 billion in investment to be lost this year\(^2\)) the rouble and stock market plunging, its credit rating marginally above junk status, and the profitability of major Russian companies taking a hit, the rationale for turning to China was clear. If Moscow showed the political willingness and economic flexibility to seal various long-negotiated deals, it had the opportunity to unlock substantial Chinese capital, while Beijing in turn stood to benefit from energy and weapons deals of considerable value. Following Vladimir Putin’s visit to China, that is exactly what happened.

The most significant breakthrough was the $400 billion agreement on gas exports, over which talks between China and Russia had been deadlocked for over ten years. While Chinese oil imports from Russia have already grown significantly, Gazprom had long been unwilling to budge from its demands for European pricing levels. China has been able to fulfill many of its needs from Central Asian suppliers, Turkmenistan in particular, but remained eager to strike a deal if the Russians moved closer to the Turkmen price. Even before the Ukraine crisis, the balance of power in these negotiations had started to shift. While China was finding a variety of alternative suppliers, Russian companies faced the prospect of major new LNG supplies being added to the global market, long-term reductions in European demand, and a variety of short-term financing issues. Xi Jinping’s visit to Russia in 2013 set the stage for a mutually beneficial solution. In one of the largest-ever global energy contracts, China National Petroleum Company (CNPC) agreed upon a $270 billion supply deal with Rosneft.

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to double oil exports to the Chinese market.\textsuperscript{22} Crucially, it included a $60-70 billion prepayment agreement, allowing the state-owned company virtually to eliminate its net debt.\textsuperscript{23}

Gazprom’s huge 30-year deal with CNPC, at volumes equivalent to one-quarter of its total sales to the European market, appeared set to apply the same model. Indications were that, thanks to the Ukraine crisis, Russia’s newfound flexibility on price\textsuperscript{24} would bring the number closer to China’s target figure, but that the pill would be sweetened with another Chinese prepayment to pay for many of the capital costs.\textsuperscript{25} The final details of the pricing arrangements for a deal that ended up going to the wire during Putin’s visit were not publicly released. Yet indications were that Gazprom had ultimately secured a price that was not too far below the European average,\textsuperscript{26} and the extended rally in the company’s stock price\textsuperscript{27} continued after the announcement. Coming at precisely the moment when the West is looking to squeeze Russia’s economy, Chinese energy experts privately acknowledged that this would go down badly in the United States and Europe, but considered the temporary opprobrium a price worth paying for a long-desired deal that will have an “impact on China’s domestic gas market, and on regional and global trading [that is] substantial and well beyond previous expectations.”\textsuperscript{28}

The gas deal was coupled with a relaxation of informal restrictions on Chinese investment in the Russian economy across a variety of sectors, from natural resources to infrastructure and real estate,\textsuperscript{29} reflecting the fact that Moscow can no longer afford to be quite as picky about the source of its financing. And economic considerations have also stimulated Russia’s new-found willingness to sell advanced defense equipment to the Chinese. For the best part of a decade, Moscow had been cautious about giving China access to military technology that could either be used to augment its capabilities in a future conflict with Russia or reverse-engineered and sold on in third markets. After 15 years of being China’s biggest arms supplier following the end of the Cold War, purchases had dwindled to virtually zero, and Chinese defense companies were turning up at international arms fairs with cloned versions of Russian fighter jets.\textsuperscript{30} But last year, faced with budget restrictions, the Russian military embarked


Not only is Chinese economic backing an increasingly important base of Moscow’s support, but there is the prospect that Russian military technology sales will directly influence the balance of power in Asia.

on a multi-billion dollar set of agreements that promise to provide Beijing with some of its highest-grade equipment. These include the Su-35 fighters, Lada-class diesel submarines, and the S-400 air defense missiles. The Su-35s, described by one defense analyst as “the best non-stealth fighter in the world today,” are superior to any plane currently available to the PLA Air Force, with the potential to strengthen China’s enforcement and deterrence capabilities in the East and South China Seas. The S-400s would for the first time give China complete air dominance of Taiwan, as well as air defense coverage of the Senkaku Islands (which China calls the Diaoyu Islands), and the capacity to defend against Indian ballistic missiles. Between them, the systems “provide the Chinese with a substantial boost in combat quality.” Until recently, there were doubts about whether some of these deals would actually go through, but the Ukraine crisis again seems to have tipped the balance — further announcements stating that the contracts would be signed this year came in March and April.

Energy sales, new investments, and arms supplies do not require China or Russia to provide reciprocal political backing for each other’s stances in Europe and Asia, and they are certainly still consistent with Beijing maintaining close ties to the United States and the European Union. They do, however, amount to a mutually enabling Sino-Russian partnership that is qualitatively different from the form it has taken in the post-Cold War period. For many years, the prospect of Western policies pushing China and Russia together, and encouraging a Russian tilt away from Europe, was too unlikely to merit serious consideration. Now not only is Chinese economic backing an increasingly important base of Moscow’s support, but there is the prospect that Russian military technology sales will directly influence the balance of power in Asia, with an adverse impact on the West’s friends and allies in the region.

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China’s Presence in Europe’s Neighborhood

The picture looks somewhat different in Europe’s eastern neighborhood, where the contest between Russia and the West is playing out over the stabilization, integration, and economic struggles of the region. As Ukraine’s second-largest trade partner34 and a major financier, China has already become directly embroiled in the crisis as a result of its economic relationship with Ukraine, though it has walked the political line very carefully. Yanukovych hoped to secure extra credit lines in China to help him through the crisis induced by failing to sign the EU association agreement.35 He left with $8 billion in investment promises but no new financing. Following his ouster in February, China was forced to deny that it was going to sue Ukraine over a $3 billion agricultural loan.36 A few weeks later, a senior China EXIM Bank official made stronger statements about China’s commitment to the country: “Chinese companies have a lot of investments in Ukraine, and the intensity will increase. We will not pull out or reduce the investments due to the current situation.”37

Neither in Ukraine nor elsewhere in the region are China’s economic objectives in individual countries going to drive its broader strategic calculations. The bigger issues at stake in Beijing’s relationship with Russia and Europe will not be fundamentally affected by a crop deal or the sale of an aging, half-finished aircraft carrier. But Beijing is not willing simply to subordinate its economic interests to Russian political objectives. China has spent the last decade-and-a-half undertaking a dramatic expansion of its trade and energy ties with Central Asia, a by-product of which has been a major rebalancing of the region’s center of economic gravity away from Moscow.38 Now in Central and Eastern Europe, there is the prospect of leveraging China’s geo-economic ambitions in a similar fashion.

One of the initiatives that Xi was keenest to tout during his visit to Europe was the “Silk Road Economic Belt” (see Figure 2). The commercial logic is that road and rail routes would provide a faster alternative to the cheap (but slow) shipping corridors, and loop the fast-growing Chinese interior provinces more effectively into global transportation routes — much as the infrastructure along China’s coasts powered the previous phase of its economic boom. The strategic logic is to reduce China’s dependence on the maritime realm for its trade and energy needs, not least as tensions with the United States and East Asian neighbors intensify.39 Last year, China launched a freight route running from the central Chinese city of Zhengzhou through Kazakhstan, Russia, Belarus, Poland, and on to Hamburg. Hewlett Packard, DHL, and iPhone manufacturer Foxconn are among the companies who have developed their own Sino-European express rail services, which

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39 For a more comprehensive Chinese exposition of the “Go West” rationale, see Wang Jisi’s “Westward: China’s Rebalancing Geopolitical Strategy,” International and Strategic Studies Report 73, Center for International and Strategic Studies at Peking University, 2012.
Kazakhstan is planning for 7.5 million containers to be shipped by rail each year by 2020, versus barely a few thousand in 2012. As a result, China has started touting Eastern Europe as the logistics gateway to European markets, and has been developing a set of infrastructure projects there to facilitate these plans. The 2013 China-CEE summit agreed to “build a new international railway transport artery linking China and CEE countries, and will encourage the setting up of bonded areas and distribution centers along the railroad” [and]


a distinct secretariat to manage the process.43 Deeper Chinese involvement in Central and Eastern Europe is by no means uniformly positive from a Western perspective. One of the largest parts of the $8 billion of China’s investment pledged to Ukraine last year was the $3 billion construction of a deep-water port on the Crimean peninsula, with a $10 billion airport, LNG terminal, and shipyard44 planned further down the line, which would form one of the nodes for the new Sino-European logistics corridor.45 Not only have Russian officials claimed that the investment is still going ahead,46 but they have been touting new plans for a Chinese-built transport corridor across the Kerch Strait47 that Russian analysts claim mean that China “de facto” recognizes that Crimea became part of Russia voluntarily.”48 Russia has a strong interest in being the primary conduit for Sino-European trade, and the Eurasian customs union was itself one of the measures that encouraged Beijing to develop the new rail corridor in the first place.49

There is little doubt, however, that Beijing plans to spread the benefits and connections around the region rather than relying on a single artery, much like the many branches of the historical trade route that the initiative is modeled on. Despite China’s ideological and strategic reasons not to want to see the West “win” this particular contest with Russia, it has certainly not signed up to Moscow’s agenda to maintain a sphere of influence that is stuck in a permanent state of economic and political dependence. While China still behaves with a modicum of sensitivity in Russia’s “backyard,” it is also well aware that in East Asia, Russia has been more than willing to develop commercial and security relationships with very little regard for Beijing’s preferences. Although it will not say as much in public, as its relationships in the region move from the bilateral to the strategic, China increasingly has more to gain from Central and Eastern Europe’s integration, prosperity, and stability than it does in temporarily helping to prop up Russian-backed kleptocrats and breakaway criminal enclaves. Chinese officials have even indicated their willingness to play a discreet role in assisting with the economic stabilization of Ukraine itself. For Western policymakers, and particularly for European officials, there is a clear opportunity to work with China to sustain and deepen its economic engagement in the region.

[Russia’s case] is the first time that these sophisticated financial sanctions have been applied to a major economy and global power, and the trade-offs for China are by no means the same.

Applying Financial Sanctions to Major Powers

A more complex balance of considerations applies when it comes to Beijing’s handling of financial sanctions. China has trodden very carefully over matters of global financial stability and the integrity of its banking sector. It has not been willing to take on major economic risks for the sake of geopolitical gambits nor to have its banks become pariahs rather than the major global actors it has taken them some time to develop.

As Hank Paulson recounts in his memoirs, when, at the height of the financial meltdown in 2008, Russian officials suggested to China that the two sides sell their holdings in Fannie Mae and Freddie Mac to force the United States to use its emergency authorities to prop them up, Beijing wanted nothing to do with it,50 a reflection of the cautious approach that it took throughout the crisis. When the U.S. Treasury embarked on the process of using financial instruments to target “rogue” states, China also took a conservative stance. So paranoid were its banks about handling North Korean funds after the Treasury’s Section 311 designation of Banco Delta Asia, a Macao bank that facilitated North Korea’s money-laundering, that a ripple of accounts were quickly frozen by Chinese institutions that wanted to retain their access to the U.S. financial system. After a political deal was forged to return


the North Korean funds, China’s central bank and finance ministry still refused to touch them, leaving the Russian central bank to take on the task.51 Chinese oil companies slashed their purchases from Iran in order to receive waivers allowing them to continue dealing with U.S. banks.52 While Chinese diplomats worked to minimize the scope of multilateral sanctions at the UN, Chinese companies and economic officials were making sure that, when it came to matters of financial legitimacy, they stayed on the right side of the line.

But Russia is a different case from Iran or North Korea. It is the first time that these sophisticated financial sanctions have been applied to a major economy and global power, and the trade-offs for China are by no means the same. For Chinese multinationals, the calculation in the case of North Korea was that the modest volume of business they transacted with Pyongyang was not worth the risk of becoming a financial pariah. Iran, a far larger economy and significant energy exporter, was a more balanced call, but the threat of U.S. fines, the difficulties of settling payments, and the reputational risks ultimately acted as a similar deterrent — not enough to stop China from sanctions-busting entirely but a major inhibiting factor. With Russia, an economy more than five times the size of Iran, not only are the sums of money at stake far larger, but the process of unwinding its global entanglements is a far more complex task. Not only is the likelihood that Chinese companies will become targets of a U.S. sanctions campaign consequently far less, and dealing with Russian firms is a more worthwhile risk to take.


The calculations over whether to assist Moscow in the face of the West’s financial pressure are not purely economic. Before the Crimea annexation, targeted financial sanctions had only been directed at states engaged in classic “rogue” practices, illicit nuclear programs, terrorist financing, proliferation, and counterfeiting. Now they are being used against a power whose economic size and membership in virtually every important global club — the P5, the G8, the WTO, and a host of others — might have been thought to protect it. It is a leap to imagine sanctions being applied to China — another five times Russia’s economic size, many times more deeply integrated with the fabric of the global economy, and with vastly greater retaliatory capacity — but the precedent has been set. Just as it would have been much harder to contemplate using these tools against Russia without the Iranian experience, the warnings from U.S. officials directed at Beijing sound more credible now than they would have done a few months ago. These are not the crude economic weapons that China faced down in the years after the 1989 Tiananmen crackdown but precision instruments that operate as much by engendering a cascade of fear in the private sector as through any sustained government actions. The ramifications for Russia have already been acute, with European Central Bank head Mario Draghi putting the existing capital flight figure as high as $220 billion as a result of what are still a very limited set of EU and U.S. sanctions.

China on the Rise in the Global Financial System

Russian firms facing difficulties accessing funds in Western markets are already turning to China for financing and access to payment systems. The issuance of “dim sum” bonds — RMB-denominated debt issued outside China — by Russian companies has been growing. While the $603 million of yuan debt they sold last year was a modest sum, and the overall market remains immature, the rationale for companies with substantial Chinese revenues to scale this up is clear. Gazprom has already mooted the prospect of further yuan bond issues, “a curtsey in front of China,” as one Russian asset manager put it. In the short-term, this would not even be close to sufficient in helping Russia avoid a sanctions-induced “Lehman moment” if its financial system hits the wall. RMB internationalization has simply not gone far enough yet for there to be any reasonable expectation that Chinese capital markets would be able to compensate Russia for the diminished access to financing from Europe and the United States. But with China’s economic base and global trading role, Beijing has the capacity to change that picture quite rapidly over the coming years. The RMB has already surpassed the euro as the second most used currency in international trade finance (see Figure 3), and is expected to push $1 trillion by the end of 2014. The sanctions on Russia provide additional geopolitical impetus to China’s moving further forward with a process that...


is likely to see the RMB become a major reserve currency, a take-off in RMB-denominated bonds, and a Chinese banking sector that grabs an ever larger share of international business.

China already has the means to assist in other ways. Russian banks have been hit by service cut-offs by Visa and Mastercard, which suspended services to SMP Bank, InvestCapital Bank, and Bank Rossiya. While the immediate Russian response was to move forward with plans to establish its own national payments system, another option under discussion is to expand the use of the existing Chinese network, UnionPay, already the third largest payment system in the world. VTB, Russia’s second largest financial institution, announced a deal with the Bank of China during Putin’s visit to develop cooperation on rouble and RMB settlements. China is also watching the debates about SWIFT, the interbank financial messaging network. When Iranian banks’ access to the system was cut off in 2012, Chinese and Russian banks — which are members — questioned whether it had become “merely a political tool of the West.” That view would be roundly confirmed if Russian financial institutions became the next target, potentially resulting in the fragmentation of the system and the loss of a reliable source of intelligence on matters ranging from terrorism to organized crime.

Operating alone, Russia does not have the wherewithal to overcome many of the most egregious effects of financial sanctions, and in the short-term, China will not move hastily to set in

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motion changes to the global financial system that would be difficult to reverse. But there is a risk that this will be a tipping point. And the implications, if China decides that its interests are best served by a move toward “de-dollarization,” extend well beyond the long-term sustainability of the Russia sanctions to encompass the basic architecture of the global economy.

The Price of Interdependence

Xi Jinping’s last stop in Europe was a visit to the institutions of the European Union, the only Chinese head of state ever to do so. In recent years, Beijing had seemed to be backing away from its earlier support for the EU as another pole in a multipolar world, happier to play divide-and-rule and transact the serious business with member states. But for the first time since the failed effort to persuade the Europeans to lift the arms embargo against China, there was a big ask for a Chinese leader in Brussels. The EU and China are in the process of negotiating an investment agreement, but Xi wanted to push reluctant European officials toward committing to the next step — free-trade talks.62 China has grown concerned that it is being left out of the action between the advanced economies, who are busy negotiating Trans-Pacific Partnership (TPP), Transatlantic Trade and Investment Partnership, and major bilateral deals that some EU officials have privately described as an “Asia-minus-one” strategy. There is even debate in China of using the prospect of joining a post-TPP agreement with the United States and a bilateral deal with the EU as a lever for economic reforms at home, much as WTO accession negotiations functioned during the Jiang Zemin and Zhu Rongji era. Europe’s complete lack of interest in entering talks with such a difficult economic partner at this stage was evident from the painful language in the joint statement that references “willingness to envisage broader ambitions including, once the conditions are right, toward a deep and comprehensive FTA, as a longer term perspective.”63 But Xi’s agenda provided a marked contrast to the debates underway in the European Council about how to disentangle the European and Russian economies. However challenging the next phase of China’s economic reforms is, the basic direction — including further and deeper integration in the global economy — is clear. Unlike Russia, Beijing’s underlying strategy hinges on its continuing to shepherd its economic ascent successfully, not throwing its weight around over territorial disputes or ideological crusades. Burgeoning Sino-European economic ties may even play a discreet role in helping to stabilize Europe’s eastern neighborhood if both sides can successfully push ahead with a major set of joint cooperation projects on infrastructure and development in the region.

Yet with Putin’s visit to China this month, Beijing’s less benign instincts have also been on display. China’s decision immediately after Obama’s “ally reassurance” tour to make assertive moves in the South China Sea by deploying an oil rig in waters claimed by Vietnam, accompanied by a flotilla of 80 ships, helicopters, and fighter aircraft, caught many analysts, and the Vietnamese themselves, by surprise. Relations between China and Vietnam had been improving and there was no obvious cause for the escalation.64 It seemed like a probe that was almost designed to underline the most

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difficult questions posed by Russia’s recent behavior— is the United States drawing a red line around its allies and leaving everyone else to their fate, or will the West defend basic international norms in the face of coercion? Does it have effective means to do so short of the use of force? Beijing hopes, and increasingly expects, that the answer to the latter question is “no.” While it is easy to dismiss the brandishing of a China option in Moscow as little more than a piece of theater, the failure of sanctions to change Russia’s course of action would be a powerful demonstration that for major non-Western powers, economic interdependence is no fundamental barrier to military assertiveness. China has little interest in seeing Russia successfully destabilize Ukraine, but it does have an incentive to squash any temptation for the West to believe that the threat of economic isolation is a viable form of deterrence. If the purchase of advanced weapons and a few hundred billion dollars’ worth of cheap gas is all that it takes, so much the better. But the exchanges between China and Russia in the months leading up to Vladimir Putin’s next scheduled visit to China in November will go well beyond that, and the Ukraine crisis could yet prove to be the catalyst not just for a new European security order, but a post-Western financial order, too.
## Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>CEE</td>
<td>Central and Eastern Europe</td>
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<tr>
<td>CNPC</td>
<td>China National Petroleum Company</td>
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<tr>
<td>ECB</td>
<td>European Central Bank</td>
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<td>EU</td>
<td>European Union</td>
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<tr>
<td>FTA</td>
<td>Free trade agreement</td>
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<tr>
<td>G7</td>
<td>Group of Seven (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States)</td>
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<tr>
<td>G8</td>
<td>Group of Eight (Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States; the European Union is represented within the G8 but cannot host or chair summits)</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>LNG</td>
<td>Liquefied natural gas</td>
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<tr>
<td>P5</td>
<td>The five permanent members of the United Nations Security Council (China, France, Russia, the United Kingdom, and the United States)</td>
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<tr>
<td>PLA</td>
<td>People's Liberation Army of the People's Republic of China</td>
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<tr>
<td>PRC</td>
<td>People's Republic of China</td>
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<tr>
<td>RMB</td>
<td>Renminbi, the official currency of the People's Republic of China</td>
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<tr>
<td>SCO</td>
<td>Shanghai Cooperation Organization</td>
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<tr>
<td>SWIFT</td>
<td>Society for Worldwide Interbank Financial Telecommunication</td>
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<tr>
<td>TPP</td>
<td>Trans-Pacific Partnership</td>
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<tr>
<td>TTIP</td>
<td>Transatlantic Trade and Investment Partnership</td>
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<tr>
<td>UN</td>
<td>United Nations</td>
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<tr>
<td>US</td>
<td>United States</td>
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<tr>
<td>USSR</td>
<td>The Union of Soviet Socialist Republics</td>
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<tr>
<td>WTO</td>
<td>World Trade Organization</td>
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