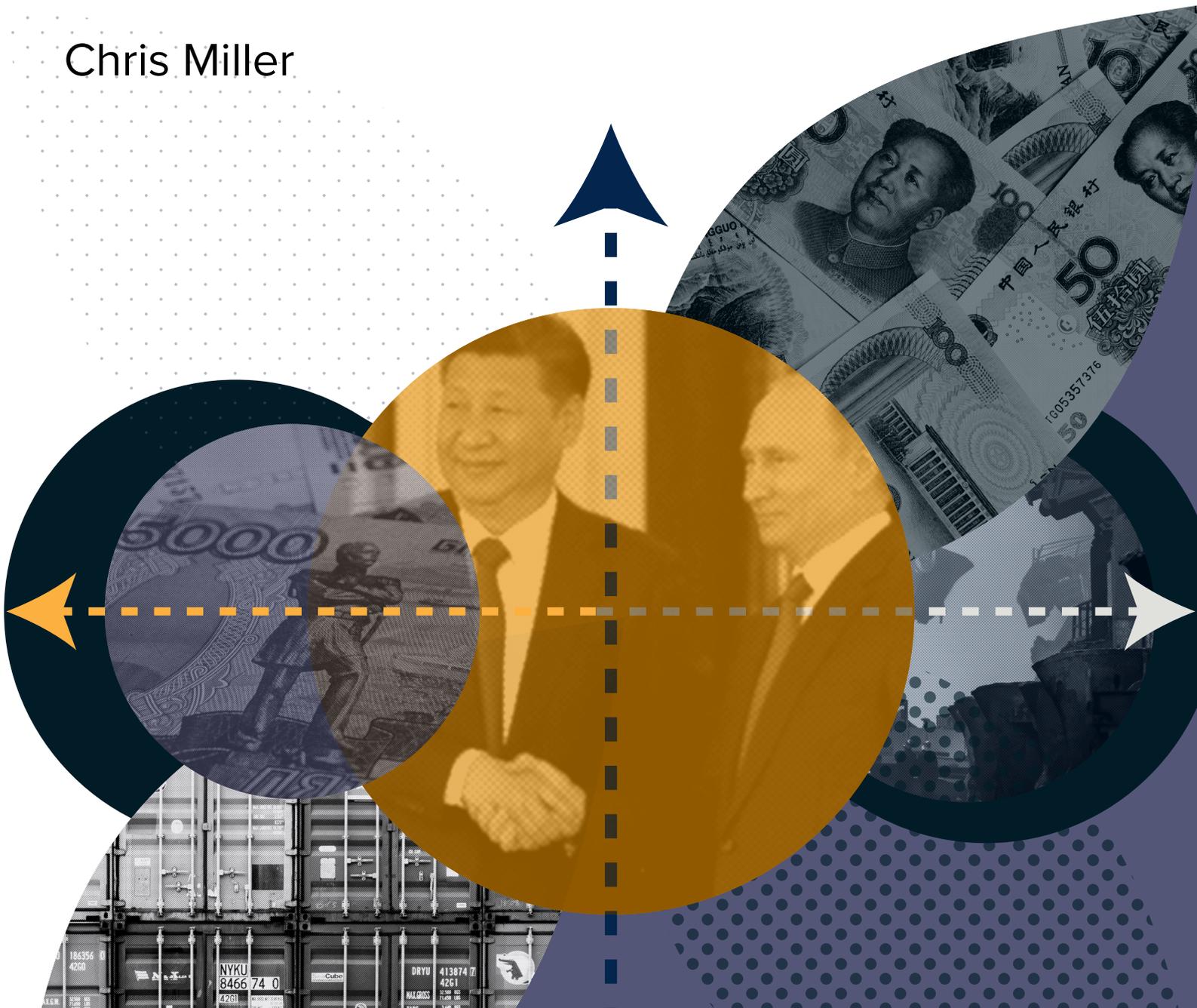
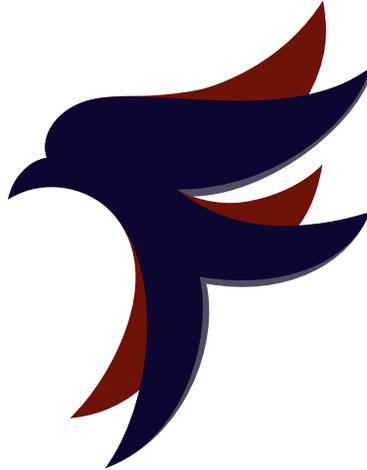




HOW WILL CHINA RESPOND TO THE RUSSIA-UKRAINE CRISIS?

Chris Miller





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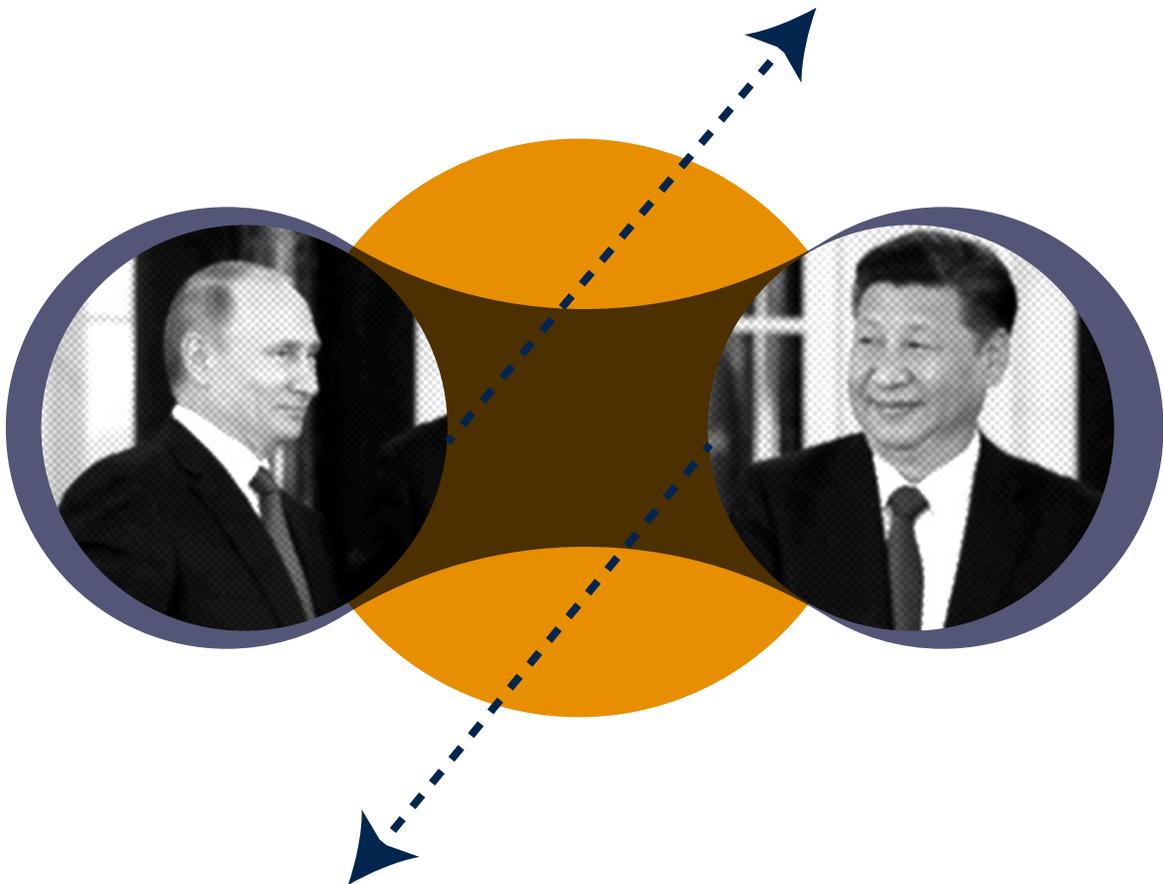
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INTRODUCTION

How will China respond to a potential Russian military escalation against Ukraine? Relations between Russia and China have intensified in recent years, with Vladimir Putin and Xi Jinping holding regular summits and the two countries' militaries participating in joint exercises and cooperating in some defense industrial efforts. Ties between Moscow and Beijing are now closer than any time since the days of Stalin and Mao, driven by a shared perception that the United States is each country's primary foreign policy challenge. One top Russian official told media in December 2021 that the relationship now "exceeds an alliance."¹ Chinese state media, meanwhile, have vocally backed Russia in arguing that the current crisis stems from the US "using NATO as a tool to cannibalize and squeeze Russia's strategic space."²

The 2014 war in Ukraine and annexation of Crimea was an important factor driving Russia and China closer to each other, as Russia sought to reduce post-Crimea international isolation and as Beijing realized it could drive a hard bargain in

its bilateral relationship with Russia on issues like energy. China's response to the 2014 war, however, was generally to avoid taking sides. China accepted a narrative that placed blame on the West for causing the crisis, with top diplomats citing Western "foreign interference for causing the crisis," but didn't approve of Russia's seizure of Crimea or its military actions in the Donbas.³ China abstained from voting on the key United Nations resolutions regarding Crimea, for example, and it still declines to recognize Crimea as Russian territory. Similarly, it verbally rejected US and European sanctions on Russia though it let Chinese firms, including the country's big state-owned banks, abide by these sanctions to avoid being cut off from US financial markets and the international banking system.

Compared to 2014, however, China may find it more difficult to avoid involvement in an escalating crisis. Leaders in Beijing and around the world will see the US response to any military escalation against Ukraine as sending signals about whether

1 Anton Troianovski and Steven Lee Meyers, "Putin and Xi Show United Front Amid Rising Tensions with U.S.," *The New York Times*, Dec. 15, 2021, <https://www.nytimes.com/2021/12/15/world/asia/china-russia-summit-xi-putin.html>

2 *Global Times*, Dec. 27, 2021, <https://twitter.com/globaltimesnews/status/1475531946998603777>

3 Somini Sengupta, "Russia Vetoes UN Resolution on Crimea," *The New York Times*, March 15, 2014, <https://www.nytimes.com/2014/03/16/world/europe/russia-vetoes-un-resolution-on-crimea.html>



President of Russia Vladimir Putin and President of China Xi Jinping visit the Moscow Zoo, June 2019. (kremlin.ru)

the US could effectively respond to future crises in the Taiwan Strait or East or South China Seas. The success or failure of US efforts to impose meaningful costs on Russia if it escalates will be seen as a test of whether the US could do something similar in Asia. Moreover, after repeated summits between Chinese President Xi Jinping and Russian President Vladimir Putin, including Xi's description of Putin as his "best friend," China's approach to Russia amid a crisis will also be interpreted as sending signals about China's own capabilities and influence.

Because of this, China will not see a new phase of war between Russia and Ukraine as a peripheral issue in its foreign policy,

even though China has no core issues at stake in Ukraine itself. China is most likely to be implicated in the crisis by potential Western sanctions on Russia, which in contrast to 2014 will impose substantially more pressure on Beijing to take sides. China's decision either to adhere to new Western sanctions or to help Russia avoid them will shape escalation pathways and determine the magnitude of economic and political isolation that sanctions impose.

CHINA'S RESPONSE TO POTENTIAL WESTERN SANCTIONS

Western leaders have signaled that, if Russia escalates militarily against Ukraine, the US, EU, and UK will respond with a new round of sanctions intended to impose substantial costs on Russia. In 2014, after some initial disagreement within the transatlantic alliance, the US and European Union imposed multiple sets of sanctions on Russia: 1. banning firms from doing business in occupied Crimea; 2. restricting the ability of major Russian companies like Rosneft and Sberbank from accessing Western capital markets; 3. limiting the transfer of certain types of oil and gas drilling technology to Russia; and 4. tightening export controls to military-linked firms, causing severe delays to certain space and aviation programs.⁴

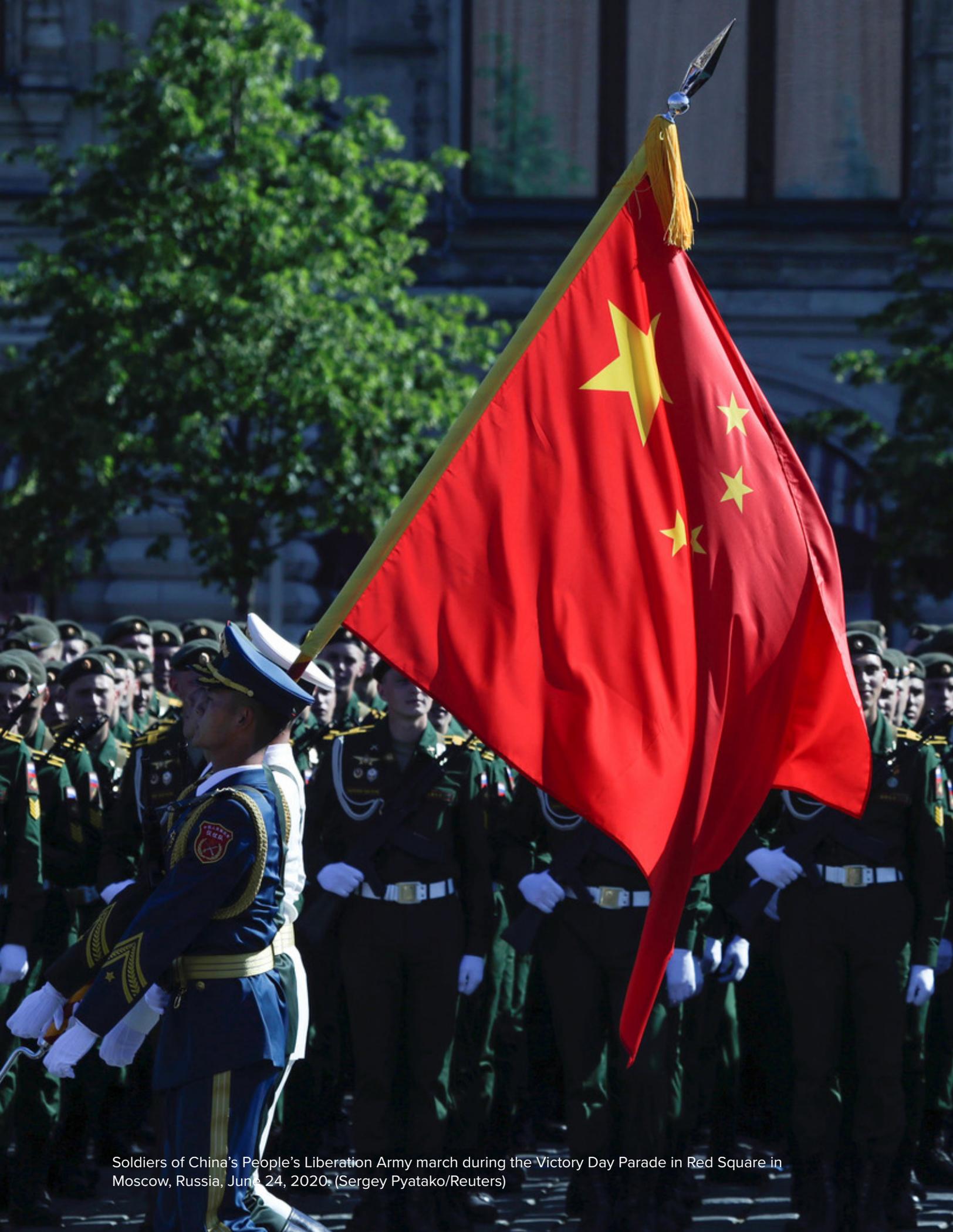
In 2014, China played no significant role in these sanctions, either in terms of shaping Western decision making or Russia's response. This was largely because China didn't have a major position in the economic sectors targeted. There wasn't substantial Chinese investment in Crimea nor did Chinese capital markets have the

capacity to replace New York or London. China didn't have the advanced oil drilling equipment placed under sanction and no significant Chinese-made goods were impacted by new export controls.

Because of this, the US and EU imposed sanctions without having to consider seriously whether and how China might react. Russia had to respond to sanctions knowing there was little chance it could count on substantial Chinese help. China played no significant role in Western decision making about sanctions and had only a small impact in helping Russia respond to sanctions in the years that followed.

If Russia again escalates militarily against Ukraine, it is not yet clear what sanctions the US and EU would mobilize in response, but many of the options being discussed would implicate China directly. Moreover, because the Russia-China economic relationship is larger and deeper than in 2014, it would be more difficult and costly for China to follow Western sanctions. As a result, China is far more likely to play an important role in

⁴ Steve Holland, "U.S. Could Hit Russia Phone, Aircraft Part Imports if it Invades Ukraine," Reuters, December 21, 2021, <https://www.reuters.com/world/europe/exclusive-us-could-hit-russia-smartphone-aircraft-part-imports-if-it-invades-2021-12-21/>



Soldiers of China's People's Liberation Army march during the Victory Day Parade in Red Square in Moscow, Russia, June 24, 2020. (Sergey Pyatako/Reuters)

crisis escalation pathways, because unlike in 2014, it won't be possible to "abstain" from making a choice about sanctions. In case of tough sanctions, China will be forced to choose. The decisions Beijing makes will either undermine sanctions or intensify their impact, in turn shaping the Kremlin's perceptions of whether Russia can weather the economic cost.

According to media reports, the West is considering several categories of sanctions that could be enacted on Russia in case of escalation. Some of these, like sanctioning Russian oligarchs or Russian sovereign debt, would be mostly symbolic, imposing little economic cost and having little chance of shaping Russia's political calculus. Other measures would be more impactful — and therefore more likely to implicate China. Three such sets of sanctions deserve special consideration: tough sanctions on the Russian financial sector; sanctions that put major Russian state-owned firms out of business; and export controls that prohibit the transfer of civilian products to Russia. Each of these would require Chinese compliance to have maximum impact on Russia.

1. Financial and Banking Sanctions

It has been publicly reported that in case of Russian military escalation, the US could impose tough financial sector sanctions by cutting off international banks' ability to convert rubles to dollars; by severing

Russia's access to the SWIFT interbank communication network, which handles most international payments; or by otherwise trying to sever Russian firms' access to international financial markets. In 2014, the US and EU already imposed some limited restrictions on major Russian firms' ability to raise capital, though these could be tightened and expanded to include more companies. The other types of financial sanctions listed above have been used against small economies, like Iran and North Korea, but never against a country like Russia, with a large economy that is deeply integrated into international financial markets. The last time a major economy was severed from international payments in peacetime was when the US imposed sanctions on Japan before World War II.

When the West imposed sanctions on certain Russian firms' access to capital markets — though took no steps limiting their ability to make international payments — China had little capacity to replace Western capital markets, because China's own capital markets are mostly closed to foreigners. Russian firms couldn't simply transfer their fundraising from London to Shanghai. The measures that China did take to help Russian firms raise money after 2014 was largely symbolic. In October 2014, right after tough sanctions were imposed, Chinese Premier Li Keqiang visited President Putin in Moscow and issued vague promises of investment, spurring news headlines like "Russia Signs Deals with China to Help Weather Sanctions," though the actual



scale of investment remained limited.⁵ At the same time, the Chinese and Russian central banks opened a currency swap line, enabling Beijing to lend renminbi, the Chinese currency, to Russia. This enabled additional headlines about financial cooperation, though it doesn't seem to have been used in a meaningful way.⁶ The only meaningful steps that China took in the years after 2014 was to allow state-owned and state-backed firms to invest more in Russian energy assets, though this occurred well after the peak of political tension in 2014-2015.

If the West were to impose strict sanctions on Russia's ability to make international payments today, the ruble would crash and Russia would have to use a substantial portion of its roughly \$500 billion in foreign exchange reserves to try to stabilize the currency and fund imports. Because Russia imports and exports more goods from China than any other country, China would be most impacted by any efforts to halt international payments. China would therefore have to take a stand on whether or not it would abide by such sanctions.

⁵ "Russia Signs Deals with China to Help Weather Sanctions," CNBC, Oct. 13, 2014, <https://www.cnbc.com/2014/10/13/russia-signs-deals-with-china-to-help-weather-sanctions.html>

⁶ Andrey Ostroukh, "Russia and China Open Currency Swap Line," *Wall Street Journal*, Oct. 13, 2014, <https://www.wsj.com/articles/russia-and-china-open-currency-swap-line-1413207546>



(Adobe Stock)

Moreover, Beijing would realize that it has an important interest in the success or failure of Western sanctions on Russia. If they succeed in imposing severe costs on Russia, Western sanctions threats against China — which could be used in case of crisis in Asia — would be more credible. If China helped Russia mitigate the impact of these sanctions, the US would lose an important tool and its ability to constrain China using economic means would be reduced. China would therefore have much at stake in the success or failure of sanctions.

Both China and Russia have invested in their own payment systems that can help them make payments without the SWIFT system, though these systems haven't been tested in real world crisis

conditions. China could help Russia by swiftly transitioning bilateral trade to other payments systems, moving trade currently denominated in dollars or euros to rubles or renminbi, and by providing generous loans in renminbi to the Russian government, central bank, and major Russian financial institutions, which could then be used to buy goods from China. Such a move would be costly for China, as some of these loans might not get repaid. These efforts would also substantially increase US-China tension. However, if such a move worked at stabilizing Russia-China trade, these financial mechanisms could also be used by third countries to transact with Russia while avoiding US financial sanctions. If so, this would demonstrate China's financial power and



the declining efficacy of US sanctions. The alternative would be to tolerate major disruptions to China-Russia trade while watching the US demonstrate sanctions efficacy, neither of which would be palatable to Beijing.

2. Sanctions on Major Russian Firms

In addition to broad, strict sanctions on Russia's financial system and the country's ability to transact internationally, the US and Europe could impose tough sanctions on specific Russian firms. To impact the Kremlin's decision making, sanctions would have to target some of

Russia's biggest companies, many of which do substantial business with China. Thus far, big Russian firms are mostly only subject to limits on their access to capital markets, but they could be targeted with tougher sanctions that make it illegal for American individuals or companies to do business with them, which in practice severs them from the international financial system. If so, any listed Russian companies' international operations would be heavily disrupted, creating risks for China but also opening opportunities for China to help such firms recalibrate and therefore undermine the efficacy of US sanctions.

In 2018, a set of poorly structured US sanctions on Russian aluminum company Rusal briefly made it illegal for

many companies to transact with Rusal, causing Rusal's share price to collapse and sparking major disruptions to international aluminum markets. The US, which was surprised by the severity of the sanctions, eventually withdrew them after negotiations with Rusal.⁷ The sanctions were highly disruptive for Rusal because they made it difficult for the company to deal with international banks and forced many customers to cancel contracts. In the future, the US could impose comparable sanctions on almost any Russian firm. Outside of the gas and oil sector — which Europe and the US depend on to keep energy prices stable, and are therefore unlikely to be targeted by sanctions — Russia has major companies in the metals and mining sector, for example, that have deep international interconnections and would therefore be highly vulnerable to US sanctions.

If the US were to reprise its 2018 sanctions on Rusal and expand them to other Russian firms, this would impose two serious costs on China. First, China would suffer from the disruptions to commodity markets that this would cause. Depending on which Russian firms were sanctioned, international markets for aluminum, nickel, copper, palladium, and other products could be disrupted, causing substantial price increases. If US sanctions proved effective at disrupting

Russian companies' ability to do business in the long-term, this would not only harm Russia, it would suggest that similar measures could also be used against some Chinese companies in the future. Either way, China wouldn't have the opportunity to sit on the sidelines.

China could respond to such sanctions by helping Russian firms avoid their impact. For example, Chinese state-owned banks or the Chinese government could provide loans to impacted Russian firms. Chinese banks could also volunteer to process international payments for them. Depending on how US sanctions were structured, this could put Chinese firms in violation of US law, but China might wager that the US would decline to enforce the law against China if doing so meant embroiling itself in a financial contest with China and Russia simultaneously. If China was able to help major Russian firms do business despite strict US financial sanctions, this would undermine the efficacy of any future US sanction program. China would demonstrate its financial power and would have financial tools that could be redeployed in future crises.

⁷ "Rusal Shares Plunge over 40 Percent on U.S. Sanctions," *Reuters*, April 8, 2018, <https://www.reuters.com/article/us-usa-russia-sanctions-rusal-stocks/rusal-shares-plunge-over-40-percent-on-u-s-sanctions-idUSKBN1HG04H>; William Spiegelberger, "Anatomy of a Muddle: U.S. Sanctions Against Rusal and Oleg Deripaska," *Foreign Policy Research Institute*, April 29, 2019, <https://www.fpri.org/article/2019/04/anatomy-of-a-muddle-u-s-sanctions-against-rusal-and-oleg-deripaska/>



3. Export Controls

In addition to sanctions on the Russian financial system or on individual Russian firms, media reports suggest that the US is also considering imposing strict export controls on Russia, including on smartphones and aircraft parts. Over the past several years, the US has imposed strict export controls, notably on semiconductor technology, to target Chinese companies like Huawei, SMIC, and Hikvision. The scope of these export controls and their ability to freeze the activities of major global firms like Huawei has surprised many observers, including in China. In a sign of the power of these sanctions, Beijing has not retaliated despite the US having targeted several of its biggest companies.

The US has long imposed certain export controls on Russia, though in the past they have mostly targeted military or dual-use goods. Now, according to media reports, the US is considering a substantial increase in the scale of export controls to include important civilian products like smartphones. Such restrictions, if imposed, would implicate China directly, especially because most smartphones are assembled in China and many smartphones bought by Russians are produced by Chinese firms like Xiaomi. However, almost all phones include US components, notably in their advanced semiconductors, and are therefore impacted by US export controls.

If the US imposes export controls on smartphones or other products, Chinese companies would have to decide whether to abide by these export controls or violate them. China's government could choose to vocally reject the export controls. If so, the US would have to choose between letting Chinese firms ignore them — thereby opening wide loopholes — or initiating a major escalation of the export control campaign by trying to punish Chinese firms for violations. Alternatively, the Chinese government could facilitate the preparation of shell companies that could manage smartphone trade with Russia. This could potentially shield smartphone producers and assemblers from being liable for export controls, though the US could still try to enforce controls against these intermediaries.

If China were to enforce US export controls against Russia, this would be a profound sign of weakness, implying that Chinese companies producing goods in China can only sell to third countries with US permission. If China were to reject US export controls, however, the US would face the unappetizing choice of launching a major new pressure campaign against China even while dealing with the fallout from a potential escalation of the Russia-Ukraine war.

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People stand under a giant screen broadcasting news footage of Chinese President Xi Jinping attending a video conference call with Russian President Vladimir Putin, in Beijing. (TINGSHU WANG / REUTERS)

ASSESSING CHINA'S RESPONSE

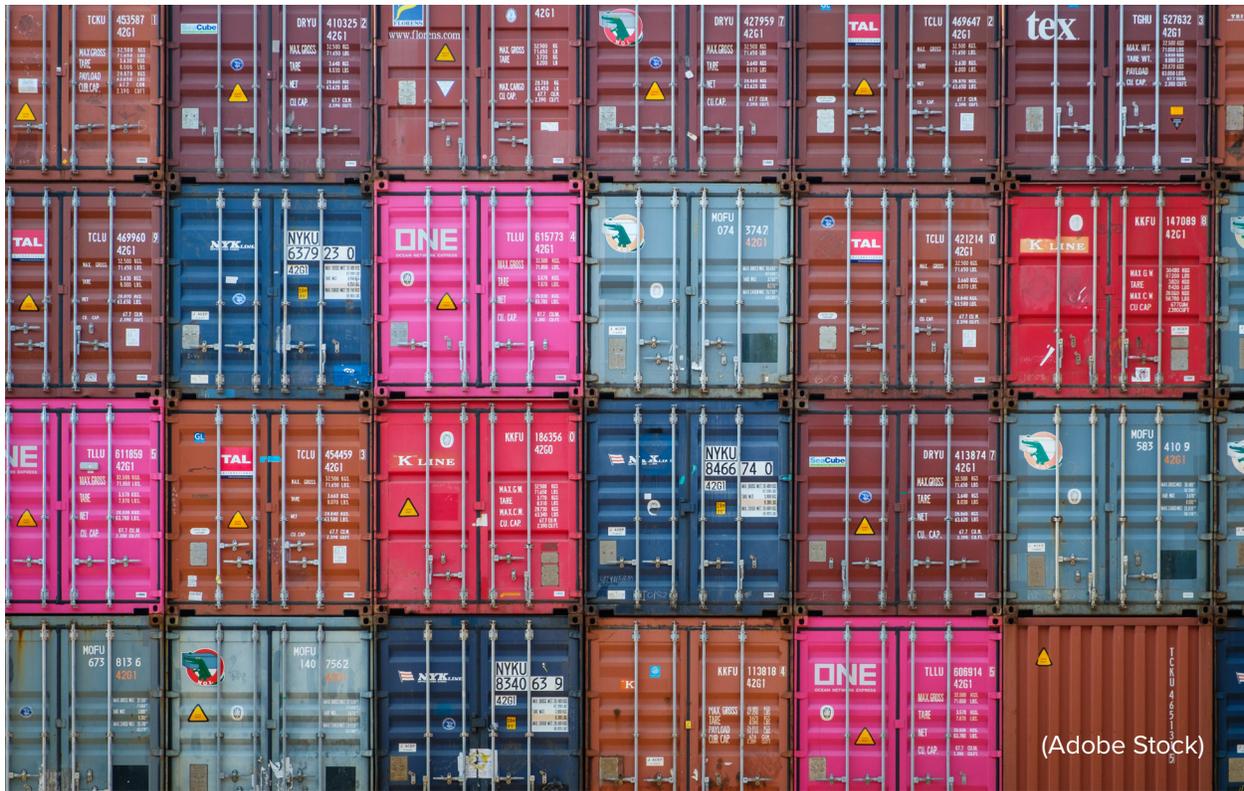
US financial sanctions have been a longstanding irritant in US-China relations. The US has accused Chinese companies of violating sanctions on North Korea and Iran, for example. Sizeable Chinese companies like Macao-based bank Banco Delta Asia and Chinese telecom firm ZTE have faced penalties and restrictions on their businesses for violating sanctions regimes. When pressured by the US, Beijing has generally let Chinese companies follow US sanctions regulations to avoid US fines and legal proceedings. This has brought embarrassment to China in the past by demonstrating its weakness vis-à-vis US sanctions. For example, China declined to retaliate after US export controls forced Huawei to sell its advanced smartphone business. Similarly, Chinese state-owned banks have enforced US financial sanctions imposed on Hong Kong leader Carrie Lam, who has publicly complained that she can't open a bank account.⁸ China's leaders have evidently decided that it is better to keep its banks plugged into the international financial system and suffer the embarrassment of having a key

official reduced to making purchases in cash since she can't open an account.

If Russia escalates its military pressure on Ukraine and the US and Europe respond with strict sanctions and export controls, as officials have publicly threatened, China would face a much more difficult choice. China's general adherence to US sanctions on Iran and North Korea (despite noted exceptions) was a comparatively easy decision because Iran and North Korea have small economies. The cost of compliance is therefore small. Russia is far larger and far more internationally connected. Because of this, comparably tough US sanctions would be substantially more disruptive to China's economy. Because China is deeply intertwined with Russia in terms of trade and, to a lesser extent, finance, it would be unable to sit on the sidelines. Beijing would either have to reject US sanctions and export controls, help enforce them, or do some mix of both. Either way, China would be forced to choose.

Most experts believe that China is unlikely to take sides in a potential Russian

⁸ Laura He, "Hong Kong Leader Carrie Lam is Getting Paid in Cash Because Banks Won't Deal with Her," *CNN*, Nov. 30, 2020, <https://www.cnn.com/2020/11/30/business/hong-kong-carrie-lam-cash-intl-hnk/index.html>



military escalation against Ukraine.⁹ In a political and military sense, this is probably accurate. However, if the US imposes tough sanctions, China won't be able to avoid tough choices. The structure of US and European sanctions in 2014 didn't impose such a dramatic set of decisions on Beijing. In 2014, almost all China-Russian trade was untouched by sanctions and most China-Russia financial flows were also uninterrupted. This time, if the West carries through on its most severe threats, the impact on China could be profound, in terms of economics, but also in terms of reputation.

If China adheres to US sanctions against Russia, Beijing's economic heft will seem less significant and America's financial power will be enhanced. This raises the stakes for Beijing, which in a crisis might conclude it has no choice but to stand up to America's extraterritorial sanction power. If so, Russia would find a valuable friend amid the crisis — and the West could find itself embroiled in a two-front financial war. 🦅

⁹ Kristin Huang, "China 'Unlikely to Take Sides' in a Russia-Ukraine Conflict," *South China Morning Post*, Dec. 7, 2021, <https://www.scmp.com/news/china/diplomacy/article/3158785/china-unlikely-take-sides-russia-ukraine-conflict>

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