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# The Sino-Russia Gas deal: the repercussions of long term asymmetric dependency

Resurgence of Russia and China Programme

Timothy Williams, June 2014



## Abstract

As Russia and China sign a 30 year gas deal thought to be worth \$400 billion; it may help compensate Russia for economic losses caused from increasing isolation from the West. This will give Russia more strategic freedom to act against the West but may also increase its dependency upon China. With increased leverages China may be more able to impose its will upon Russia when they have foreign policy divergence and may alter Russia's relationship with its near abroad in Central Asia. Putin's attempts to hedge against China will fail to make a significant impact.

***The signing of the recent Russia-China gas deal*** at the end of May 2014 will have wide reaching consequences for Russia-China relations, as well as being indicative of a major geopolitical shift. The deal is worth an estimated US\$400 billion over 30 years and from 2018 onwards will involve Russia supplying China with 38 billion cubic metres (bcm) of gas per year.<sup>1</sup> It has been seen as a major boost for Russia, demonstrating that through increased economic integration with China it can deflect Western attempts to isolate it. Although it is difficult to determine the long term impact of the deal, it is indicative of a growing asymmetric dependency in China's favour, which will significantly alter their strategic relationship.

The Sino-Russian gas deal comes on the back of the recent Ukraine crisis, the Russian annexation of the Crimea and the West responding with limited

sanctions. The Ukraine crisis itself is unlikely to significantly weaken Russia economically in the short term as they still have significant reserves of Foreign Exchange of around US\$400bn.<sup>2</sup> If Western sanctions increase then Russia may start to quickly deplete reserves to support the value of the Rouble and offset

the increase in capital flight. However Russia already has many deep structural problems with its economy including low growth, corruption and a declining population meaning that growth is forecast to be only 0.2% in 2014.<sup>3</sup> The price paid by China for the gas is shrouded in secrecy although it is likely to be far less than market prices in Western Europe and Asia, but even at these prices the agreement could be worth up to \$13bn a year to Russia. This will help to secure Russia's economy in the medium term, both by providing foreign exchange and by reassuring investors. It will also boost bilateral trade which was already over \$90 billion in 2013. As a result, President Putin has said that the two countries had 'reached a new level of comprehensive partnership and strategic cooperation'.<sup>4</sup>

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China and Russia have been negotiating the deal for the past 10 years, unable to come to a final agreement over

price and other issues. The Ukraine crisis significantly weakened Russia's negotiating position, giving China far greater leverage over the negotiations and Russia a sudden urgency to have foreign investment. The circumstances of the deal suggest that Russia was forced into

making large concessions in order to finalise the deal.

Although Russia has benefitted, China has received a major boost from the deal.

Since 2011 China has sought to quickly increase the use of gas in the national energy mix, which has been dominated by coal. This change has occurred because of an ever increasing demand for energy to feed the economy and from domestic pressures to reduce the

high level of pollution in China which has elicited domestic political dissent. This matters as environmental activism has become one of the largest forms of social unrest in China.

China has quickly transitioned to using gas as in 2013 China consumed 170bcm of gas, which they aim to increase to 260bcm by 2015 and 460bcm by 2020, accounting for 10% of China's overall energy consumption.<sup>5</sup> The gas deal therefore means that China has a secure provision of below market price gas with the potential for increased supply in the future.

Although the Russia-China deal is only equivalent to about 38bcm per year, combined with other sources of gas will allow China to reduce its dependence upon coal and subsequently reduce the high

levels of pollution in major Chinese cities.

This would go some way to quelling domestic dissent, demonstrating that Xi Jinping and the Chinese Communist Party are responsive and accountable to the people. Having a more secure domestic situation will also allow China to exert more influence internationally, to undertake its foreign policy goals with less fear of domestic upheaval and have greater strategic freedom. However whilst both

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states have benefitted from the deal, it shows a level of increased Russian dependence on China which will have major repercussions for their long term strategic freedom.

Before the Ukraine crisis

there already existed an asymmetric dependence in China's favour, but the growing isolation between Russia and the West will make this more pronounced.

Five issues have increased Russian dependence on China and so increased Chinese leverage in future areas of conflict.

1. The EU Commission recently announced that it is seeking to reduce its dependence on Russian gas.<sup>6</sup> This is because of Russia's willingness to use pipeline politics to pressure its regional neighbours as well as EU members. It is

also being seen as a punitive measure in response to Russia's recent foreign policy. As the EU currently purchases 160bcm a year from Russia, efforts to reduce this will affect Russia far more than the recent gas deal with China. This decoupling from the West would further increase China's leverage, enabling it to seek even cheaper gas in future deals and if China took up some of the lost output, it would increase Russia's dependence on China further, as the only major gas buyer.

2. The second element of the deal which may increase Russian dependence is the finance for deal. The infrastructure required is likely to cost about \$75-80bn

for gas field exploration, pipeline construction and other infrastructure. Russia has agreed to invest \$55bn in the project; however

there have also been reports that they conceded advanced payments from China to develop the infrastructure in order to get the deal.<sup>7</sup> Even if China does pay the \$25bn in advance to develop the infrastructure, Russia will still have to pay \$55bn towards the project. As previously mentioned, the Russian state still has significant foreign exchange reserves but it will be reluctant to use these unless necessary. If the US and EU extend sanctions to the financial sector, or even if

they stop short of this, it is unlikely that banks which rely on the goodwill of western governments will be willing to lend to the project. An option would be to seek finance from Chinese banks, which would further increase Russia's dependence on China. This has already occurred for the oil sector when China lent Russia \$25bn to develop the East-Siberia Pacific Ocean Pipeline (ESPO).<sup>8</sup>

3. The Ukraine crisis and poor economic conditions have led to large scale capital flight by Western companies, which could amount to between \$50-200bn and this could become far worse if the West introduces tighter sanctions.

There have also been reports that Chinese investors may replace EU investors in Russia to compensate for the loss of

capital.<sup>9</sup> It is unclear how realistic this prospect is, however if it did occur, China would have the option of investing the capital elsewhere in the future, thus further increasing its leverage.

4. The deal may signal a major change in the way energy markets and global trade functions. The dollar has been the major currency that energy is traded in for decades but the Chinese Renminbi (Rmb) could become a major alternative currency for the energy market. The Rmb

**China will be able to use its increased leverage against Russia to further its own foreign policy goals**

has already been used in Brazil, the Middle-East and the increased Russia-China energy trade conducted in Rmb will likely increase the Yuan's importance. This would create a major power shift to Beijing in the long term. China could use this currency supremacy to further its own ends in the same way that US control of the dollar allows it to exert control on international financial flows. It would give China far more leverage over the international system, especially with countries isolated from the US. Although this is unlikely to occur in the short to medium term, it may lead to Rmb hegemony in the future.

**China will have the potential to remake the global system if it achieves Yuan hegemony in the future**

5. Russia will remain only a part of China's gas mix with the rest coming from other sources including Central and South East Asia, the US, Middle East and domestic Chinese production. China will be able to increase or decrease its consumption of Russian gas without dramatically affecting itself, although it would have a far greater impact upon Russia. This will be more pronounced if Europe radically reduces its consumption of Russian gas. China also has a large storage capacity for gas which would allow it to minimise the domestic impact if

it decides to use gas as leverage in the future.

The gas deal therefore feeds an increasing asymmetric dependency, stacked heavily in China's favour. China will begin to use the leverage to gain preferential conditions for its business interests, which could affect Russian economic growth and government finance. China may also use to further its foreign policy goals, especially when Sino-Russian interests diverge. A major area where they are likely to clash is

Central Asia where Russia has been trying to assert its hegemony but China has become the main trading partner to all former Soviet states in the region, except for

Uzbekistan, where it is the second.<sup>10</sup>

In the past year China signed major regional investment packages including \$30bn with Kazakhstan, a \$15bn deal with Uzbekistan and \$3bn financial aid with Kyrgyzstan, in industries ranging from oil and natural gas to infrastructure projects throughout the region. Russia has recently pushed its interest in the region by creating the Eurasian Economic Union (EEU) and by extending its military presence in Kyrgyzstan and Tajikistan by committing nearly to \$1.5bn for rearmament of the armies in both states.<sup>11</sup>

However with its increased leverage, China will be more willing and able to support its Central Asian trading partners if Russia tries to impose its political will on them and in the process threatens Chinese investments. This may alter the behaviour of the Central Asian states, making them more willing to defy Russia if they feel they have China's support. This has the potential to dramatically change Russia's relationship with its near abroad, especially in central Asia.

In the short to medium term Russia will benefit from the China gas deal and potential Chinese investment support but it is clear that Russia has been forced by circumstances into a position where it had to accept less advantageous terms. The deal will not fully compensate for the incurred losses if the EU reduces its consumption of Russian gas. It has also created a growing dependency which will significantly weaken it in the future and less able to assert itself, even in its near abroad if its goals clash with those of Beijing. The more that Russia becomes isolated from the West, the more dependent it will become upon China.

Although this relative decline against China was already well established, by weakening ties with the West, Russia has

sped up its transformation into a vassal state; at least in terms of foreign policy in East and Central Asia. China no longer fears encirclement by the US and Europe that it previously did during the 1990s with Russia's participation in NATO's Partnership for Peace Program. These recent improved relations have ensured at Russia will remain China's 'safe rear'.

If Russia further decouples from the West and aligns more closely with China, Beijing is likely to allow it a free reign in Europe but will constrain Russia's goals in Central and East Asia. China likes to have a powerful ally on the world stage and so is unlikely to press Russia too much in the

**Russia may find itself as the junior partner in an alliance with China and be unable to extricate itself**

short term, although this may change in the future. If both States accept this then they may eventually

become allies and have a similar relationship to the USA and Canada, with the northern neighbour predominantly supplying energy to the Southern economic powerhouse. However this seems unlikely as they still have historic grievances including the 1858 and 1860 treaties which awarded Russia 1.5 million square kilometres of former Chinese territory, regarded by many Chinese as 'unequal', and is viewed in a similar way to the lease of Hong Kong, which expired in 1997.<sup>12</sup>

China's foreign policy under Xi Jinping will continue to seek its narrow national interest and he is not afraid to be assertive to achieve this. He has already consolidated his own power domestically and will increasingly use China's dominance to further its own goals, even if they clash with Russia's. With Russia as an acquiescent ally China will be able to succeed in its own strategic goals without having to worry about Russia.

However Putin is unlikely to accept this junior role in the future and will resist it.

As President he has reformed Russia by strengthening the central government and restored some of its former prestige after a decade of decline under Boris Yeltsin. He has achieved this through his individual brand of nationalism, nostalgic veneration of the USSR and profits from the energy sector which have enabled him to begin to rebuild the former Soviet Union. This image of power has given Putin domestic legitimacy and become part of modern Russian identity; however this will be threatened when it becomes clear that Russia is submissive to China's foreign policy. To avoid complete dependence Russia will hedge against China by

**In the Zero sum game that Putin plays, he has already lost to China**

spreading investments and economic links with states unaligned to China including India, Vietnam Japan and in Central Asia. We can see evidence of this as Russia has sought Indian, Southeast Asian, South Korean, and Japanese investment in Russian East Asia. Russia also elevated relations with Vietnam to that of a strategic partnership, whilst increasing arms sales to South and South East Asia and exploring oil opportunities in Vietnamese territory, in contradiction to Beijing's wishes.

However this will not significantly reduce their dependency because of the inherent weaknesses with the Russian economy, the relative insignificance of current economic ties with these countries and the asymmetric dependency already established.

Should Russia want to change its role in a future partnership, it will find itself shackled and dependent upon China. Putin has been pushed by circumstance into a position of strengthening China more than he wished and Russian strategic independence will suffer in the long term. In the Zero sum game that Putin plays, he has already lost to China.

## **ABOUT THE PROGRAMME**

As the US starts to scale down its 'heavy footprint' from the Islamic-world; the resurgence of new powers becomes crucial to evaluate. The rise of today's regional and tomorrow's global power and their internal and external policies will determine future discourses. Among the rising economies and military powers; Russia and China stand out the most.

Russia has become a key global actor in the aftermath of Syrian revolution. It is the first time since the end of the cold war that Russia is not only directly involved in managing global affairs but has even managed to dictate them in Syria as well as in Georgia. Taking further advantage from its new role of an emerging global power; Russia is now seeking new relations in different regions of the Islamic-world i.e. Middle East (Egypt, Syria), Central and South Asia etc.

Chinese foreign policy in the different regions of the Islamic-world can be seen a combination of foreign policy approaches. The over-riding themes of Chinese foreign policy however remains limited to the projection of 'soft power' mixed with economic interaction and developmental strategies. This paradigm may not be sustainable in the near-future as the global system seems to shift towards multi-polarity. Chinese inter-relations with the US hard power and their economic interdependency may empower its soft foreign policy approaches. If however, these trends continue to change as the current geo-strategic trends demonstrate, Chinese foreign policy may have to radically change in terms of projecting its economic and military power in order to cater for its huge energy demands, resources and raw material etc.

Furthermore; although China and Russia may have different geopolitical interests; they have also found common grounds and convergences of interests on different global issues. As the US tries to 'rebalance' Asia Pacific and Eastern Europe: the convergences of interests are likely to steadily grow in the near to mid-term future. Finally; as the internal unrest grows in many parts of the Islamic-world; the role of emerging power such as China and Russia will be hugely important to monitor.

### ***KEY FEATURES OF THE PROGRAMME***

- Analysis of China and Russia's historic development in the last few decades.
- Analysis of contemporary socio-political trends within China and Russia.

- Analysis and evaluation of current Chinese and Russian foreign policy models and paradigms, particularly in the regions of the Islamic-world.
- Exploration and evaluation of China and Russia's military and defence strategies.
- Exploration and evaluation of Chinese cyber-warfare capabilities.
- Analysis of fragility or sustainability of western power and Pax-Americana.
- Analysis of the inter-relation of the emerging powers i.e. India, Brazil, Vietnam, Indonesia, Myanmar etc. with China and Russia.
- Analysis of new blocs particularly Shanghai cooperation organisation (SCO) or ASEAN and Chinese influence and Russian led 'custom' and 'trade' Unions.
- Establishment and anticipation of different Chinese and Russian foreign policy models, using 'futurology' studies and by the above mentioned analyses of current and emerging trends etc.

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## End Notes:

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