



Policy Brief | #2022/01

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The War against Ukraine – 5 Takeaways for China and Their Implications for the EU

China is closely following Russia's ongoing brutal war against Ukraine. The consequences it will draw from the war for its national policies will substantially impact the future of its already strained relationship with the European Union.

China's diplomatic shilly-shallying in the war against Ukraine has pushed its western partners to the edge of their patience. G7, EU and NATO made very clear during the summit marathon in Brussels at the end of March 2022 what they expect from China: Stay clear from Russia, do not circumvent sanctions.

Even though China has more or less continued its balancing act of "pro-Russian neutrality," it also has its reasons for treading cautiously in a situation that has reinforced and welded together the transatlantic alliance to an unexpected degree. This situation, especially in regard to common western sanctions, is undoubtedly unnerving from a Chinese perspective, and China's possible take-aways from it will shape future relations with the EU and other western nations. At least five are ready at hand.

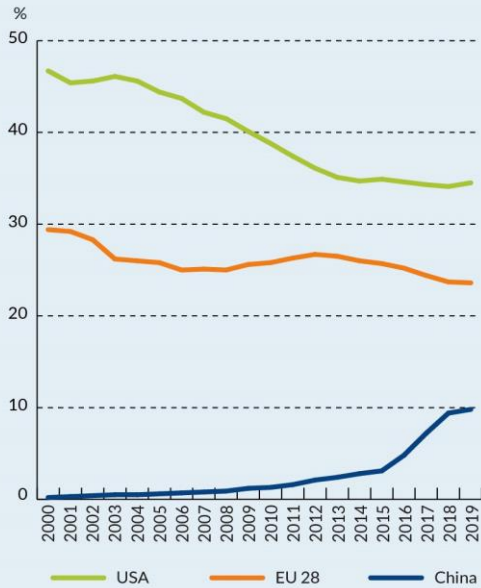
#1 Pushing technological (in)dependencies

China set the goal to become a global technology and innovation leader by 2049 in its industrial policy strategy "Made in China 2025" (MIC 2025), announced in 2015. Homegrown technology and indigenous innovation are at the core of this strategy, which focuses on ten key sectors, such as high-end machine tools, robotics, artificial intelligence, IT and e-mobility.

The graphs below show that China has already made huge progress in many of these technologies, as measured in the Chinese share of world-class patents. These are patents that are particularly technologically relevant and provide good insight into the innovative strength and technological development of an economy.

Key technologies: Mobility and Energy

Mobility: Share of world-class patents
USA-EU-China, 2000-2019 (in percent)



Mobility includes the following technologies:
Autonomous Driving, Electric Vehicles, Drones,
Smart Traffic, Air and Spacetech

Energy: Share of world-class patents
USA-EU-China, 2000-2019 (in percent)



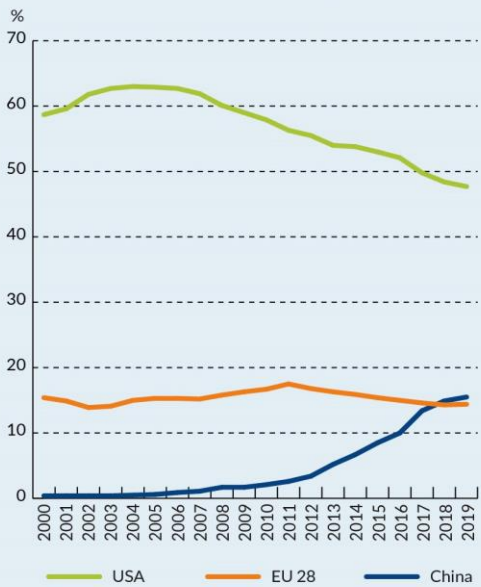
Energy includes the following technologies:
Geothermics, Hydropower, Wind, Photovoltaic, Solar Thermal,
Battery Tech, Energy Saving, Energy Conversion, Biofuel/Biomass

Source: Bertelsmann Stiftung 2020

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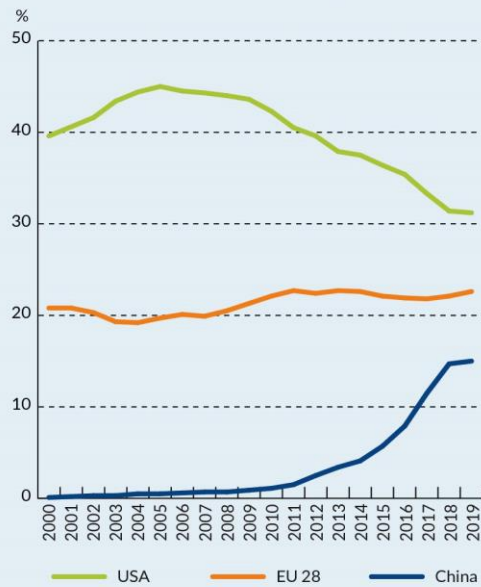
Key technologies: Digitisation and Industry

Digitisation: Share in world class patents
USA-EU-China, 2000-2019 (in percent)



Digitisation includes the following technologies:
Artificial Intelligence, Big Data, Blockchain, Cloud Computing,
Virtual Reality, Quantum Computing

Industry: Share in world class patents
USA-EU-China, 2000-2019 (in percent)



Industry includes the following technologies:
Additive manufacturing, Smart Factory, Robotics,
Process Automation

Source: Bertelsmann Stiftung 2020

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China's share of these patents has increased by more than 50 percent annually on average since 2010, gaining even more speed since the introduction of MIC 2025. However, it also becomes clear from the graphs that there still is a gap between China and western countries, especially the United States, in many areas. Among them are technologies such as artificial intelligence or smart manufacturing, that are especially important for the implementation of both MIC 2025 and the twin transition to a green and digital economy, which are closely interlinked.

Even before the war against Ukraine, it was a political priority for China's government to reduce the country's dependency on foreign know-how, especially since U.S. sanctions against Huawei nearly killed the company's smartphone business and made crystal-clear how lethal this kind of critical dependency can be. Western sanctions against Russia have taken things up another notch: They show that not only the United States but a larger number of – not only western – countries are willing to resort to or at least support this kind of measures to an unprecedented degree.

Consequently, the war against Ukraine will accelerate the Chinese leadership's push for independence in key technologies, especially by reinforcing efforts to reduce the reliance on western inputs. China will certainly also strengthen the strategic assessment of current western dependencies from Chinese inputs that could be exploited politically if the need arises and explore options to create new such dependencies regarding future key technologies.

#2 Pushing alternative financial structures

China has not been happy with the USD-centric international financial architecture for quite a while and is exploring alternative structures to diversify its cross-border financial options and reduce its potential vulnerability to western financial sanctions. Western sanctions against Russia due to its annexation of Crimea were a wake-up call in this regard, and the war against Ukraine will be a powerful accelerator.

China has several options to work on the de-dollarization of its financial system. These are the evolution of its Cross-border Interbank Payment System (CIPS) and its digital currency (E-CNY), as well as the diversification of its reserve assets. China introduced CIPS in 2015 to establish an alternative financial structure. However, CIPS still has one major shortcoming: It relies on SWIFT as a cross-border messaging system for financial transactions. So, for the time being, CIPS is a blunt sword to withstand financial sanctions linked to SWIFT. To make it sharp, China would have to develop an alternative messaging system and involve a critical amount of willing participants. Given China's economic size, this is not unfeasible, but it takes time and effort to build.

The same is true for China's digital currency (E-CNY), which was introduced in 2021 and is currently tested for national use in some major cities. The E-CNY might be used to bypass financial sanctions in the future, but at present it is still in its infancy. So China will certainly see to making its digital currency fit for international use in the next decade.

Top-10 Countries with Highest Gold Reserves (in tonnes and percent)

Rank	Country	Tonnes	Share in Total Foreign Reserves
1	United States	8,133	66 %
2	Germany	3,359	66 %
3	Italy	2,452	63 %
4	France	2,436	58 %
5	Russian Federation	2,299	21 %
6	China	1,948	3 %
7	Switzerland	1,040	5 %
8	Japan	846	4 %
9	India	755	7 %
10	Netherlands	612	56 %

Note: Holdings as of December 2021 for Switzerland and of January 2022 for all other countries.

Share in reserves refers to the value of gold reserves in USD as calculated by the World Gold Council.

Source: World Gold Council.

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China is also working on the de-dollarization of its reserve assets. Increasing gold reserves and diversifying foreign reserve currencies are two important means to achieve this. China has nearly doubled its gold reserves since the imposition of Western sanctions against Russia in 2014. However, its share of gold in total reserves (3 percent) is still dwarfed against that of the United States or some single EU Member States, such as Germany (each at around 66 percent).

As for the composition of China's foreign exchange reserves, the USD and Euro, as the top-2 global payment currencies, are estimated to make up 60 percent and 20 percent, respectively, together accounting for a towering 80 percent of reserves. For further diversification, the key question would be, into which currencies to diversify? Twelve of the top-20 global payment currencies are those of western democracies, 13 if Japan is included. And it is rather unlikely for China to regard the currencies of South Africa or Mexico as an alternative, especially since, apart from the lack of scale and stability of their currencies, those countries have close economic ties with the West, too.

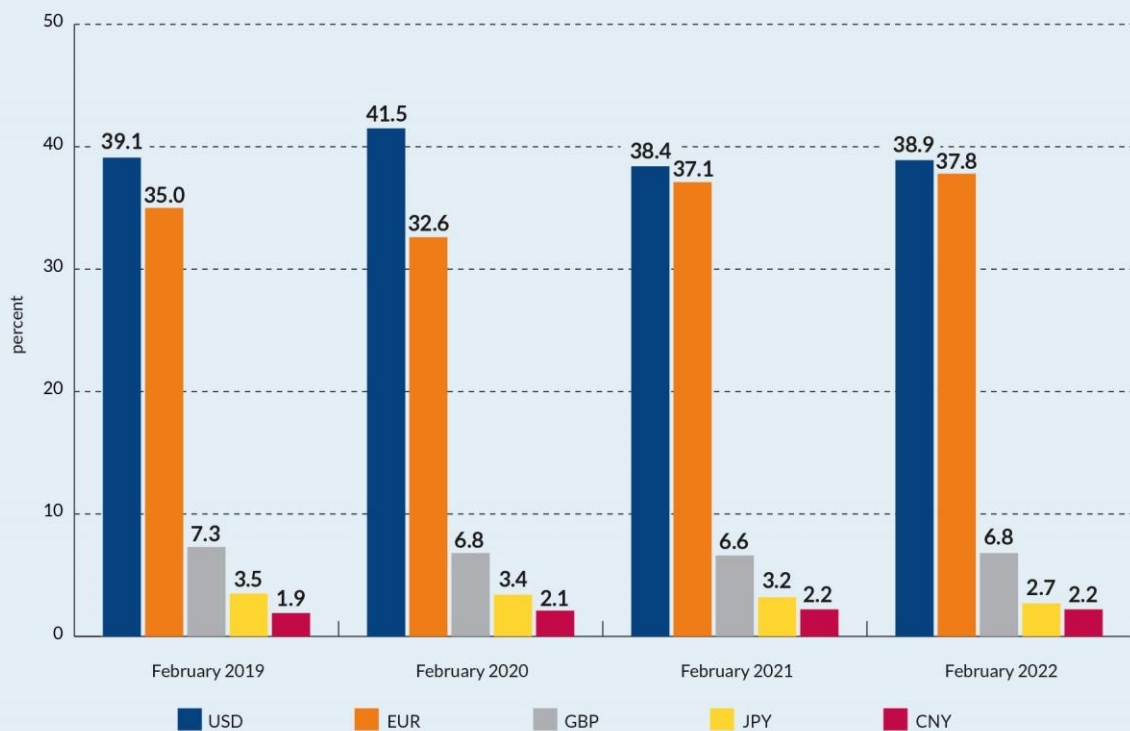
In the mid to long-term, China will likely instead focus on the other two options to build an alternative financial structure and continue to gradually strengthen the CNY as a global payment currency.

#3 Pushing energy security

Its rise as "the factory of the world" and an economic superpower has made China both the world's largest consumer of energy and the world's largest emitter of carbon dioxide, as fossil fuels still make up 85 percent of China's energy mix (see chart farther below). Domestic energy sources fall far short of covering domestic demands.

China has been a net importer of oil since 1993, coal since 2002, and natural gas since 2006. In its efforts to diversify its energy mix away from coal, China has, on the one hand, substantially increased its share of renewables, hydro and nuclear power from a mere 8 percent in 2009 to 15 percent in 2020. On the other hand, it has also become more reliant on oil and gas and thus on imports of these (see charts farther below.)

Top-5 Global Payments Currencies (in percent)



Note: Share refers to messages exchanged on SWIFT based on value.
Source: SWIFT RMB Tracker.

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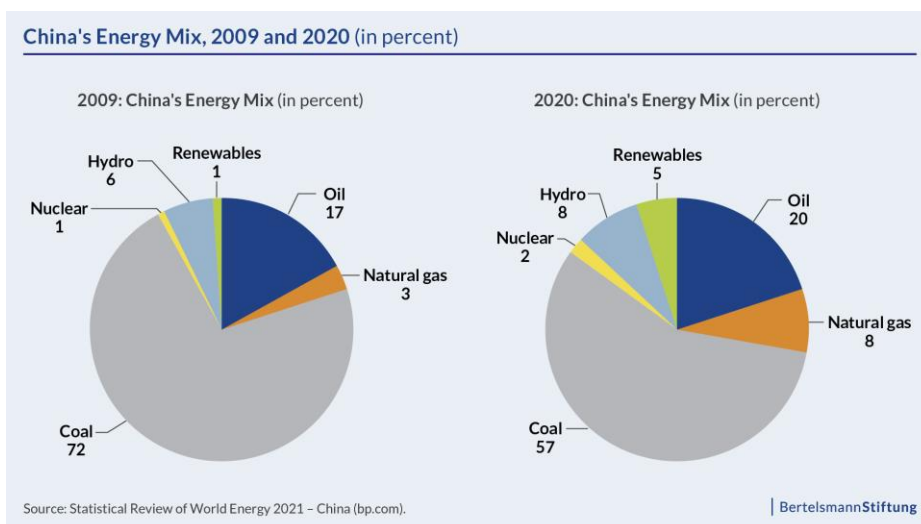


Heavily relying on foreign resources to fuel its economy makes China vulnerable to so-called choke points. One of them is the Strait of Malacca (the passage between Malaysia, Indonesia and Singapore), which it is estimated that about 80 percent of China's maritime oil imports have to pass through. The Strait is as narrow as 1.5 miles at one point and thus could easily be blocked. The unintended blockage of the Suez Canal in 2021 showed how much damage such an interruption of trade can inflict upon supply chains of goods.

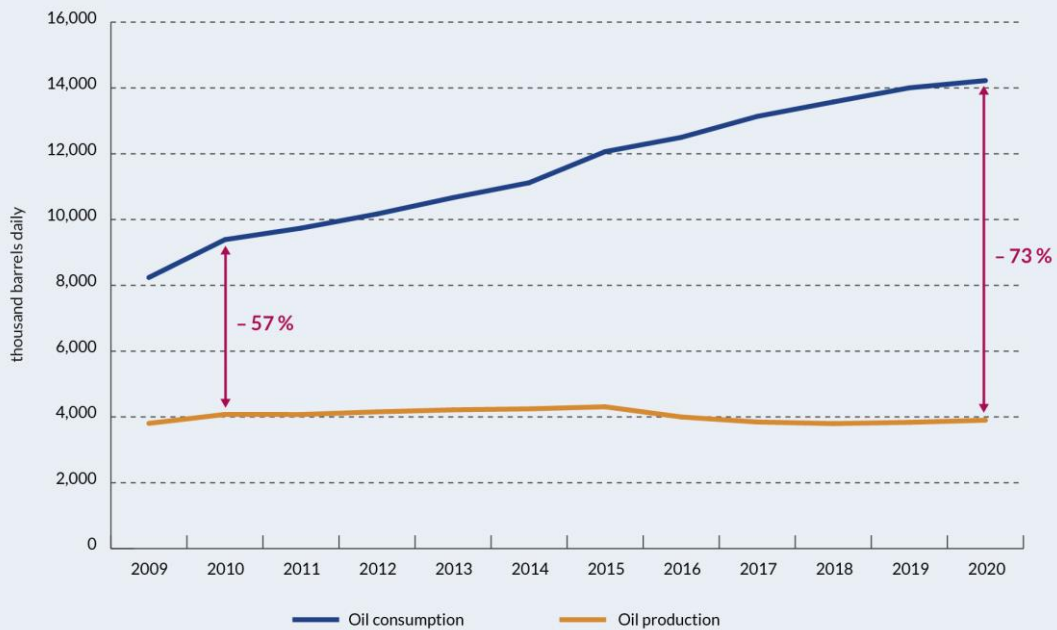
A cut-off from energy sources vital for the functioning of an economy as big as China's could do even worse. Moreover, the ongoing conflicts in the South China Sea and the unresolved Taiwan issue, which – should it come to a military

escalation – could even involve armed conflict with the United States – generally make China's reliance on fuel imports by sea a liability for its energy security.

In the wake of the Ukraine conflict, China will likely accelerate its efforts to secure its energy supply from sources that are less prone to geopolitical conflicts, such as long-term contracts with like-minded countries that can deliver fuels via a land route. The recent gas deal with Russia is already one step in this direction. An even stronger push for the green transformation and massive investment in all non-fossil primary energy sources available as well as in green hydrogen as a key secondary energy source will be another result.



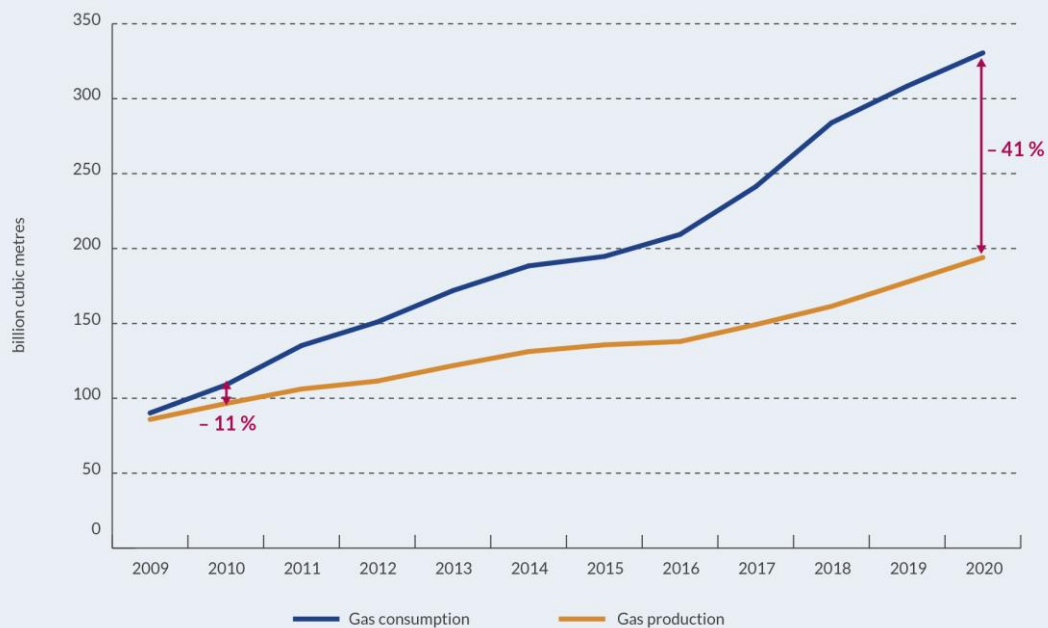
China's Oil Production and Consumption, 2009-2020 (thousand barrels daily)



Source: bp Statistical Review of World Energy 2021.

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China's Natural Gas Production and Consumption, 2009-2020 (billion cubic metres)



Source: bp Statistical Review of World Energy 2021.

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#4 Pushing military development

Developing “world-class forces” is an integral part of China’s goal to become a global superpower by 2049. Therefore, Chinese leadership under Xi Jinping has introduced important reforms to modernize the organization, structure and operational capacities of the People’s Liberation Army (PLA). Military expenses have steadily

grown in recent years to bolster these efforts. At an estimated 252 billion USD, China has the second-largest annual military expenditure worldwide, right behind the United States. But it’s still dwarfed by the latter’s 778 billion USD (see chart below). Shortly after Russia’s invasion of Ukraine, China announced a 7-percent increase in its official defense budget (not directly

comparable to the SIPRI estimates used in the chart below) for 2022, up from a 6.8 percent increase in 2021. In terms of expenses per capita of armed forces personnel (a rough proxy for the equipment of an army, e.g. in regard to high-end and digital technology and training) China also lags well behind the United States.

Therefore, an important step for further modernizing the PLA is increasing the army's mechanization, informatization, and intelligentization making it capable of intelligentized warfare. China wants to achieve this goal by 2027, and it is assumed that a strike against Taiwan, which requires complex joint operations, is substantially more credible after that period.

Taiwan most certainly is the key issue for China when observing and analyzing Russia's military progress – or rather regress – in Ukraine. And the unexpectedly miserable development of the Russian invasion is most likely to gain intense attention from the Chinese leadership. First, they will scrutinize the key factors at play here to draw lessons for China's own military. According to current analysis, these include misjudgment of the adversary's capabilities, operational and logistical mismanagement and cumbersome top-down command structures. But also communication and motivation issues among the troop. Secondly, China will probably also reassess the compilation and sources of its arms

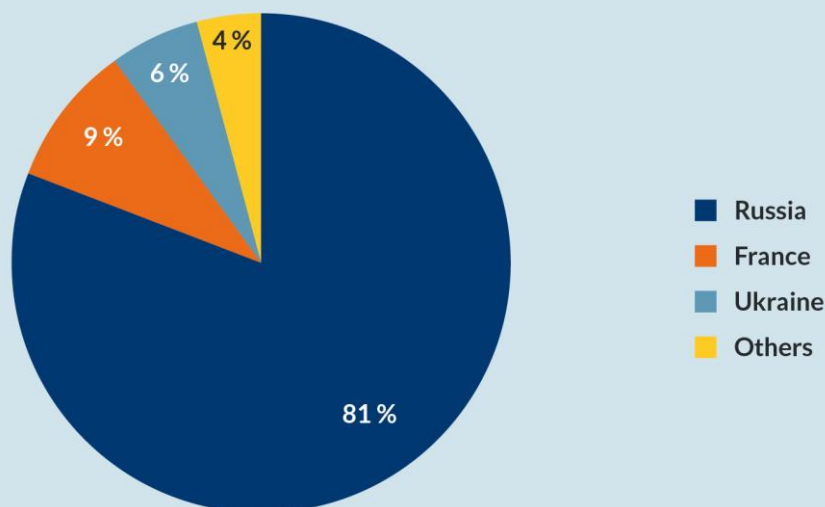
imports, 81 percent of which came from Russia between 2017 and 2021 (see chart below), to check whether diversification is required and possible. Thirdly, China is likely to push investments in high-end equipment and training of its forces as well as the development of domestic military technology with much more might than before.

#5 Pushing the “new world order”

The last takeaway for China actually is a cumulation of the previous four: Pushing its technological and financial independence, its energy security and military development is the foundation for a “new world order” with Chinese characteristics. According to China's take, this new world order under Chinese leadership, which is the core of Xi Jinping's vision of a “community with a shared future for mankind,” is supposed to be more equal, more inclusive and multipolar. Countries will be able to freely choose their own development path and socio-political system. Non-interference in countries' internal affairs will be a key principle – as opposed to the current US-led order, which China regards as increasingly unipolar, confrontational and unstable.

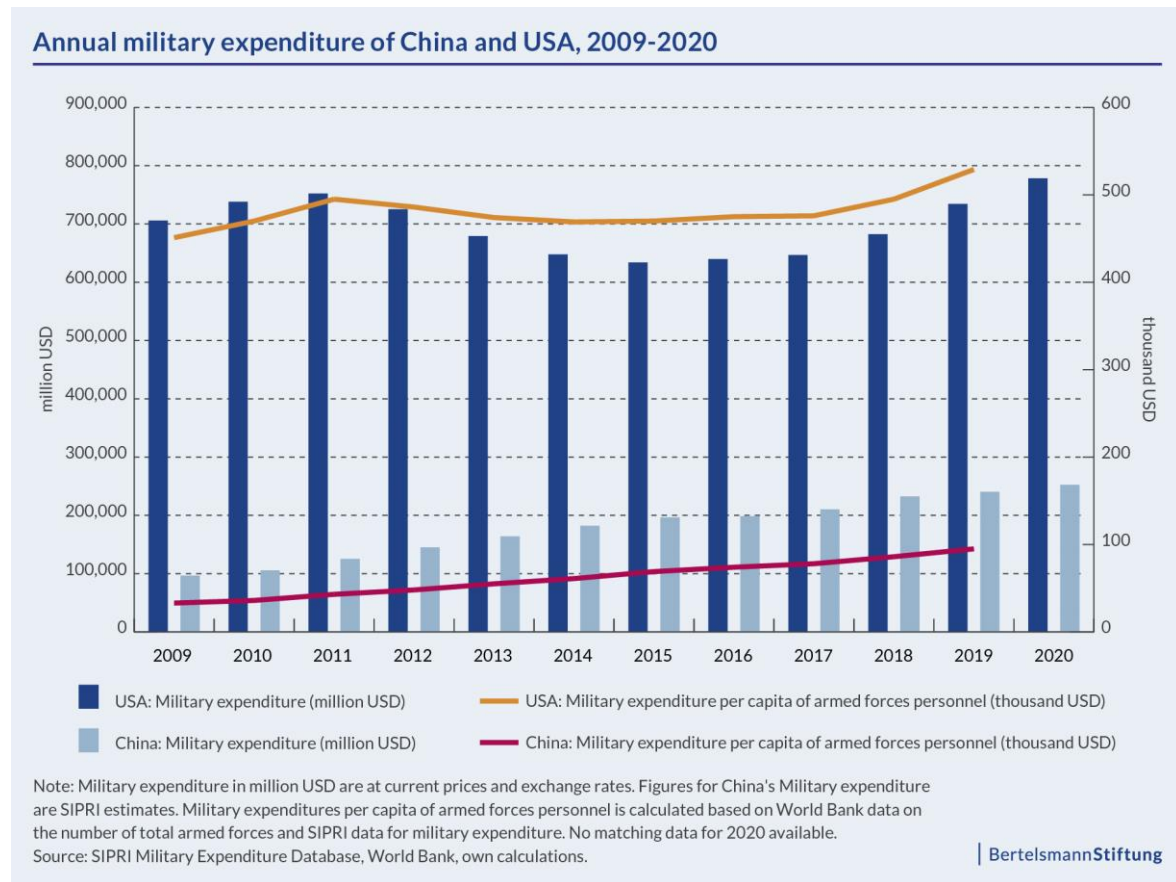
To achieve this, China actively participates in existing international and regional organizations and agreements to make and, if need be, change

China's Main Suppliers of Major Arms Imports, 2017-2021 (in percent)



Notes: Data are published for 5-year intervals. See for details on the methodology.
Source: Trends in International Arms Transfers, 2021 (sipri.org)

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rules – not just follow them. It currently heads, for example, two UN agencies, the Food and Agriculture Organization (FAO) and the International Telecommunications Union (ITU).

China has also raised the wish to join the Comprehensive and Progressive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), a free trade agreement connecting the Asia-Pacific region to Latin America. Its predecessor TPP was initially supported by the United States but dropped by the Trump Administration, leaving a power vacuum that China would not at all mind filling.

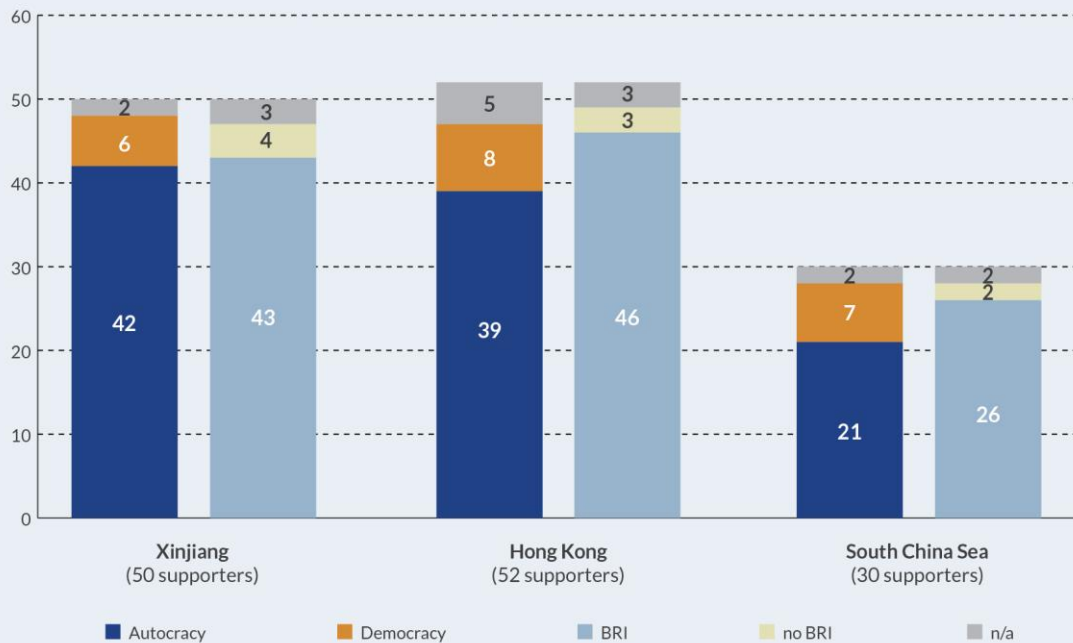
On the other hand, China pushes its own initiatives to build alternatives to western structures and approaches that bolster its own global leadership claims. The Belt and Road Initiative (BRI), a globe-spanning connectivity plan, is a much-cited example of how China has been trying to influence other countries and turn their international positioning in critical issues in its favor.

Looking at three different internationally contested Chinese policies – the treatment of the Uyghur

minority in Xinjiang, the New National Security law for Hong Kong and the territorial conflict in the South China sea – one can see that the overwhelming majority of the 72 countries supporting China in at least one of these policies share two characteristics in common (see chart below): first, they are official participants of the BRI; second, they are autocracies according to the Bertelsmann Transformation Index (BTI), which analyses the political systems of 137 developing and emerging countries. Moreover, nearly half of them are African countries, showing how well China has already spread its economic and political influence on the world's second-largest continent, while the EU is still struggling to find the right approach towards it.

In its own neighborhood, China is expanding its political, economic and military influence through plurilateral and bilateral agreements, such as the Regional Comprehensive Economic Partnership (RCEP), a free trade agreement initiated by the 10 members of the Association of Southeast Asian Nations (ASEAN) plus Japan, South Korea, Australia and New Zealand, or most recently a new security pact with the Solomon Islands.

Political System and BRI Participation of Countries in Support of internationally contested Chinese Policies



Notes: Xinjiang supporter refers to the 50 signatories of a letter to the UN Human Rights Council backing China's policy in the region in 2019. Hong Kong supporter refers to the 52 countries (excluding China itself) defending the new National Security Law for Hong Kong at the UN in 2020. South China Sea supporter refers to those 30 countries who supported China's position in its dispute with the Philippines on territorial claims in the South China Sea prior to the ruling of the Permanent Court of Arbitration in 2016.

Sources:

Xinjiang: The "22 vs. 50" Diplomatic Split Between the West and China Over Xinjiang and Human Rights - Jamestown

Hongkong: The 53 countries supporting China's crackdown on Hong Kong (axios.com)

South China Sea: Arbitration Support Tracker | Asia Maritime Transparency Initiative (csis.org)

Participation in the Belt and Road Initiative (BRI): Countries of the Belt and Road Initiative (BRI) - Green Finance & Development Center (greenfdc.org)

"Political System according to the Bertelsmann Transformation Index (BTI): " Transformation Atlas 2022 (bti-project.org)

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This is also against the backdrop of more and more Western countries adopting Indo-Pacific strategies. China suspects the goal of which is containment and even the creation of an "Indo-Pacific version of NATO to maintain the US-dominated hegemony." From a Chinese perspective, this proves yet again the unhealthiness of the current order.

China, therefore, understands Russia's security concerns, as NATO has moved ever closer to its borders. From the Chinese point of view, the war against Ukraine is the very result of these actions, and "the US, the habitual boat-rocker, is the culprit for the ongoing crisis." The war could thus play into China's hands in the long run, as it is driving deeper the wedge between mainly western liberal democracies on the one side and autocracies as well as countries that want to remain flexible (e.g., India) on the other. It could act as a catalyst for

Chinese global ambitions and lead to a full-fledged alliance of autocracies or at least consolidate China's own alliance of like-minded countries, which for various reasons are in favor of a rearrangement of the current international order.

Implications for the EU and its relations with China

The relations between the EU and China are already on thin ice. The EU-China virtual summit on April 1st, 2022 – the first such high-level meeting for two years – did nothing to change that. On the contrary, it showed even more openly how different the views of both sides are on key issues, such as the war against Ukraine. China also made its displeasure clear (between the lines) on the revitalized transatlantic alliance, which threatens its own geopolitical ambitions. Xi

Jinping “called on the EU to form its own perception of China and adopt an independent China policy”, meaning one that is independent from that of the United States.

However, if China strives for the implementation of its vision for the world, the EU is left with little choice but to do precisely that: pivot even more strongly towards the United States, as long as they have leadership that shares the liberal democratic values on which the current international order is built. Since the future of the US administration beyond 2024 is highly unclear, the EU should – just as China does itself – first internally push its sovereignty and independence, or in the EU’s own words, “strategic autonomy.” And secondly, readjust its external relations, especially with respect to developing and emerging countries.

Regarding the first aspect, the EU cannot resolve its technological and energy-related dependencies in the short term. Still, wherever possible, it certainly could choose more wisely on whom to depend. Like-minded countries like the United States should be the first choice here to avoid political exploitation of critical dependencies by autocratic regimes. Moreover, since the green and digital transformation are likely to generate new dependencies, the EU should also strive to actively and strategically manage these from the start or even avoid them by making sure EU players are part of the game.

As for the second aspect, the EU should rethink its approach towards other regions, such as Africa. If the EU is determined that liberal democracy along with universal human rights, as well as high labor, social and environmental standards are better alternatives than that offered by China and other autocracies vying for influence in developing and emerging countries – more political and economic efforts to prove it must follow. Given such a potent opponent as China, the emerging “competition of systems” will not be easily decided in the EU’s favor.

Under these circumstances, EU-China relations are now poised to enter a phase of increasing divergence, distance and decoupling. Nevertheless, both sides should prevent the ice from breaking in the end. They should strive to keep open channels for exchange and

cooperation, even though these will unavoidably be narrower than in the past and, especially on the side of the EU, better-armed with new instruments of defense against the geo-politicization of economic relations.

Further Reading

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