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## China: an emerging stakeholder in Eastern Europe

In the 22 years since the collapse of the Soviet Union in 1991, the geopolitical space occupied by the former Soviet Union has undergone far-reaching political, economic and social change. The weakening of the Commonwealth of Independent States (CSI) as an integrative structure, open competition between the economic interests and macroeconomic projects of the former Soviet Republics, both as individual competitors and as smaller groups, and rivalry between old and new interstate organizations have broken up the post-Soviet space into new geopolitical entity. The geopolitical salience of the post-Soviet space stems from the status of a crossroad, a transit area (transport, energy) between Europe and China and Europe and the Greater Middle East<sup>1</sup>. Over the past few years Russia has been making efforts to regain influence in the region relying on a rich spectrum of means – stretching from soft instruments to coercive power and even the use of military force (see cultural affinity, the progressive institutionalization – for example the Collective Security Treaty Organization, the Customs Union between Belarus, Kazakhstan – the negotiations on the gas price, loans, acquisition of strategic assets, military presence, and the Georgian war). However, considering the economic and demographic prospects, a gradual weakening of Russian influence might be expected. The post-Soviet space is fluid and increasingly competitive with many actors, besides Russia, chasing their interests<sup>2</sup>.

The EU through the European Neighbourhood Policy (ENP) and later with the Eastern Partnership (EaP), aimed at enhancing relations with Eastern European countries (Belarus, Ukraine and Moldova) and the Caucasus countries (Armenia Azerbaijan and Georgia), is promoting democracy and economic integration.

<sup>1</sup> A. BALCER - N. PETROV, *The Future of Russia: Modernization or Decline?*, in *Demos Europe*, Warsaw, 2012, p. 36.

<sup>2</sup> On the Russia's strategy towards post-Soviet space see S. GIUSTI, *La Proiezione esterna della Federazione Russa*, Pisa, ETS, 2012, pp. 83-108.

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### ABSTRACT

The post-Soviet space is fluid and competitive with many actors, besides Russia, chasing their interests. Recently, also China has gained the position of a stakeholder. Eastern European countries offer China a number of advantages while they see it as an opportunity to improve their economy. China is offering its rewards without imposing "conditionality". In political terms, Beijing's economic support can increase their bargaining power vis à vis Moscow while providing a relief to those countries "penalized" by Brussels. In the short and medium term, the Chinese presence in Eastern Europe can even underpin Russia influence in the region. The economic support Beijing is providing in particular to Belarus and Ukraine is reinforcing these countries leadership, respected in Moscow but not appreciated in Brussels. However, it is difficult to predict if and when Beijing's economic leverage could result in a more political ambition over the region, clashing not only with Russia's influence but also with other actors' plans.

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The EU strategy contemplates new Association Agreements (AAs) with those countries willing and able to enter into a deeper engagement and gradual integration in the EU economy. It would also allow for easier travel to the EU through gradual visa liberalization, accompanied by measures to tackle illegal immigration but without so far any commitment to membership<sup>3</sup>. Generally, EaP countries judge the EU paybacks not so attractive for complying with Brussels' conditionality<sup>4</sup> and for tolerating, as a consequence, its meddling in their domestic affairs. The EU's political control over national politics is a particularly delicate question. Some of the EaP countries have authoritarian regimes while others are not yet consolidated democracies and, all of them are still struggling with a complex and multi-dimensional transformation process<sup>5</sup>.

The US, another actor active and dynamic in the area, have engaged audaciously in supporting civil society during the "colored revolutions", notably in Georgia (2003) and Ukraine (2004). Furthermore, Washington has challenged Russian influence over former Soviet Republics by backing Western-oriented organizations such as the Organization for Democracy and Economic Development (GUAM) instituted in 2001 by Georgia, Ukraine, Azerbaijan and Moldova. In April 2008 the US, however, failed to convince their European allies, in particular France and Germany, to open up the NATO's Membership Action Plan to both Georgia and Ukraine. The Obama administration has been more cautious with Moscow because of its needed support in Afghanistan and the shared plan for reducing military expenses.

Over the past few years, China has also gained, for the first time since the collapse of the URSS, the position of a stakeholder, albeit not the first ranking player. Chinese investment has been flowing in particular into Central Asia at an impressive rate, particularly in the energy mining and construction sectors. Chinese companies have a significant share in the construction sector, realizing among others strategic infrastructural projects directed at diversifying transport routes between China and Europe (for example the Central Asia-China gas pipeline that is supplied by gas from Kazakhstan, Uzbekistan, and Turkmenistan). In 2010 China became the largest trader in Central Asia for the first time and Chinese FDI's also incremented significantly in recent years. Among the middle powers active in the post-Soviet space (India, Iran, South Korea, Japan) Turkey' presence is reinforcing especially in the South Caucasus, also for cultural links and religious affinity (relations are very intense with both Azerbaijan and Georgia while the Nagorno-Karabakh conflict hinders dealings with Armenia) and Central Asia (particularly in Tajikistan and Turkmenistan)<sup>6</sup>.

This analysis focuses on the increasing role of China in Central Europe, in terms of objectives and tools and it explores its leverage implications in a space where powers such as Russia, the EU and the US are traditionally committed with an 'apparently' more elaborated and multi-dimensional strategy.

<sup>3</sup> The EU is offering EaP's partners an Association Agreements (AA) including a Comprehensive Free Trade Agreements (DCFTAs) which represent an ambitious commitment towards trade, liberalization, regulatory alignment and deeper economic integration.

<sup>4</sup> The EU conditionality – setting rules as conditions that the recipients have to fulfill in order to receive rewards – has for instance shaped the Central and Eastern European countries which were obliged to develop their administrative capacities in complete convergence with the *acquis communautaire* in order to join the Union. The ENP still conceptually relies on conditionality as to the main tool to promote legislative approximation.

<sup>5</sup> With the two zones of influence – the EU and Russia – intersecting as they do, a competitive atmosphere has set in. Both seek greater institutionalization, though they differ in their basic values and in what they are able to offer. This has encouraged national leaders (most markedly in Ukraine) to draw tactically on support now from Brussels, now from Moscow, for domestic and often personal reasons. Such oscillation by national elites is hardly conducive to consolidating democracy. On the oscillating position of Ukraine and the political stagnation in Belarus, see S. GIUSTI - T. PENKOVA, *Ukraine and Belarus: Floating between the EU and Russia*, in F. BINDI (ed.), *The Foreign Policy of the European Union Assessing Europe's Role in the World*, Washington, The Brookings Institute, 2012.

<sup>6</sup> On the Turkish role in the Post Soviet Space see A. BALCER, *An Audit of Power: Turkey's Leverage in the Post Soviet Space*, Centre for Economics and Foreign Policy Studies, Black Sea Discussion Paper Series 2012/3.

## China in Eastern Europe

In this part of Europe, China, is exhibiting its “contextual intelligence” (consisting on the capacity to align tactics with objectives and to create smart strategies in varying situations) combining economic tools and political sensibility for promoting its multi-dimensional interests in a highly competitive milieu. What are the reasons behind Beijing new trajectory across Eastern Europe?

First of all, the rise of influence of China, as in other parts of the world, is due to its own capacity of investing and the availability of financial resources to do it (China is the world’s second largest economy, with budget reserves estimated at around US\$3 trillion). China is willing to diversify its export and investment and it wants to safeguard its stashes against a loss of value due to volatile currency markets and the unfolding debt crises in the US and Europe. Chinese sovereign funds and public or quasi-public firms shop around for more deals on everything from public utilities to valuable international assets. The 2008 crisis has, on one hand, exacerbated the tendency to branching out clients and, on the other hand, has made it easier. China has used financial assisting and investment also to countries that have traditionally looked to Russia. Its activism in Eastern Europe benefitted from a much more relaxed political climate with Moscow testified by a number of significant agreements on energy stipulated in recent years. China, the world’s second largest oil consumer and third largest oil importer and a small but growing consumer and importer of natural gas, is looking for security of supply and the diversification of its imports while Russia, the world’s second largest oil producer and exporter and the world’s top producer and exporter of natural gas, is seeking security of demand and less dependency on export to Europe.

The Sino-Russian bilateral engagement is very pragmatic not being so far a long term and comprehensive strategic alliance. Their new entente does not threaten western interests. Moscow and Beijing are more interested in engaging with the West than with each other and China is in a stronger position than Russia to challenge the West’s global preeminence<sup>7</sup>. So, while Russia economic penetration in Eastern Europe aims also at strengthening its political influence on the region, China seems to have a less politicized and a more mercantilist approach<sup>8</sup>. These two approaches are not at present colliding. However, it is difficult to predict if and when Beijing’s economic influence could result in a more political ambition over the region, clashing not only with Russia’s ascendant but also with other actors’ plans.

In the short and medium term we expect, on the contrary, that loans and grants settled with Belarus, Moldova and, Ukraine might weaken Western organizations (EU, IMF, World Bank) leverage in Eastern Europe matching, as a result, Russia’s national interests in the post-Soviet space. While any kind of economic aid coming from the West entails the respect of certain conditions (stretching from politics to economics) Chinese economic incentives are not bound to any political requirement. For semi/partial democratic or autocratic regimes this means above all an assurance on the continuity of power (that is Lukashenko or Yanukovich). Not only, Chinese support is also seen as a counterbalance to a dangerous deep economic dependency on Moscow that does not hesitate to use coercive power if the former Republics do not align on its requests. As Balcer and Petrov point out, «The Chinese engagement in the Eastern Partnership meets the approval of many local politicians inclined towards a multi-polar foreign policy which is based on a maneuvering between superpowers in order to benefit from the difference between them»<sup>9</sup>.

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<sup>7</sup> B. LO, *Ten things everyone should know about the Sino-Russian relationship*, CER Policy Brief, December 2008.

<sup>8</sup> On the economic activism of Russia in the post-Soviet space after the 2008 crisis see S. GIUSTI, *Russia in crisis: Implications for Europe* in P. DELLA POSTA – L.S. TALANI (eds.), *Europe and the financial crisis*, London, Palgrave, 2011, pp. 242-253.

<sup>9</sup> A. BALCER – N. PETROV, *op.cit.*, p. 46.

China's interest in Eastern Europe in many ways comes late, after it poured money into natural resource investments in Central Asia and Africa. But Eastern European countries hold plenty of attractions – low taxes, military technologies, a well-educated workforce but with factory wages much lower of those in Western Europe, and an easy access to the EU single market and since 2010 to the Custom Union instituted by Russia, Belarus and Kazakhstan.

Eastern European countries primary interest in attracting Beijing investments and capital is to improve their overall economic prospects. Economic cooperation with Beijing is seen an opportunity to boost their modernization agenda. Many of the post-Soviet states and Russia itself are redesigning relations and foreign policy objectives in harmony with the internal project of modernization. Chinese FDI is also a channel for transferring Chinese technology to the region<sup>10</sup>.

### China in Ukraine

The economic co-operation between Ukraine and China has been developing rapidly, and trade volumes have been growing, although its structure is unfavorable for Ukraine. This country exports mainly iron ores to China (almost 80% of exports), and imports predominantly processed goods. In 2011, China was Kyiv's third largest trade partner, with a share of 3.2% in Ukrainian exports and 7.5% in imports.

Bilateral cooperation includes various sectors but two sectors in particular have been favored: agriculture and energy. The two countries are building an agricultural park in Ukraine that would help manage crop and livestock, process agricultural products, conduct scientific research. A new agreement signed in September 2012 will allow the Ukrainian government to immediately attract up to US\$3 billion in Chinese investments in agricultural development. Chinese investment activities in the country are expected to receive a further boost this year when a law that permits the sale, lease and purchase of agricultural land will come into effect. This prospect however is creating concern since the law could pave the way for a Chinese growing takeover of Ukrainian fertile agricultural land as it is happening in Kazakhstan. However contrary to Kazakhstan, Ukraine is not contiguous to China and so the risk of a Chinese "conquer" trough lands control does not exist.

In the field of energy Ukraine and China are engaged in the development of alternative energy sources starting from converting Ukrainian alcohol factories to factories that will produce biofuel<sup>11</sup>. On August 2012, the Ukrainian government with NJSC Naftogaz and China Development Bank signed framework agreement on target cooperation on the program "Substitution of Imported Gas with Ukrainian Coal" that will attract the Chinese credit at US\$3.6 billion for realization of projects on substitution of Russian gas with Ukrainian coal. The credit line will be opened for 19 years (2012-2031). It is planned to implement some projects on the switch of heat supply facilities to the consumption of coal and build brown coal and coal gasification plants in Luhansk, Donetsk and Odessa regions using Shell technology tested in China. Prime Minister Mykola Azarov said that the implementation of the first five projects replacing natural gas with domestically produced coal will enable Ukraine to cut its gas imports by over 3 billion cubic meters and save around US\$1.2 billion annually<sup>12</sup>. This agreement responds to Ukraine need for energy diversification and to its will of reducing gas dependency on Moscow. The Chinese-Ukraine energy entente could irritate Russia that, however, has many potential clients for its gas, among those certainly China is a frontrunner.

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<sup>10</sup> On China's outward FDI flows by sector and largest investments in Eastern Europe see T. Apoteker, *Chinese Investment in the Greater Europe Zone*, ECRAN, London, 2012.

<sup>11</sup> T. ADELAJA, *China Stands to Benefit as Russia and Europe Cool Toward Ukraine*, «Russia Profile», 7 September 2012, <http://russiaprofile.org/international/60797.html>.

<sup>12</sup> <http://www.interfax.co.uk/ukraine-news/naftogaz-raising-3-656-b-from-china-bank-to-replace-gas-with-coal/>.

China and Ukraine are reinforcing also **military co-operation**. **The EU has applied an embargo** on arms trade with China while Russia is cautious in exporting its weapons to the country. As a result through Ukraine, China can acquire equipment and technologies developed by the Russians. In 2011 some 43% of Ukrainian products were delivered to China. In 2002 the Industrial Policy Ministry of Ukraine and the Chinese Commission for Science, Technology and Industry for National Defense (COSTIND) signed a protocol on cooperation in the sphere of the aircraft industry. Ukraine is a showcase of the political consequences of China's economic leverage. In July 2010 the IMF agreed a new, two-and-a-half-year lending programme worth US\$15.2 billion, allocating the first tranche at the end of 2010. However, there were no IMF disbursements in 2011, owing to the government's failure to raise domestic gas tariffs. Instead, the government focused on renegotiating the gas agreement with Russia from 2009 which in April 2010 brought to the signing of the much contested Kharkiv Accords. The key feature of the Kharkiv Accords was an extension of the lease on the Black Sea port of Sebastopol to Russia by an additional 25 years from 2017 to 2042 in exchange for a 30% reduction in the price Ukraine pays for gas between 2010 and 2019<sup>13</sup>. In the course of 2012 the economic co-operation with China intensified in view of developing domestic coal resources so as to reduce dependence on Russian gas and eventually increase Ukraine's bargaining power in gas price negotiations with Gazprom. In June 2012 Ukraine and China even agreed on a currency swap deal between central banks of the two countries that is expected to give the country some relief after the failure of negotiations with IMF. The National Bank of Ukraine believes that currency swap deal will promote investment and trade in Ukraine, as well as ensure financial stability in the country and enhance the export-import operations. However, as the economic problems mount (in particular the sharp deterioration in the consolidated budget deficit) Ukraine will need the help of Western multilateral organizations. The extension of the existing agreement with the IMF for another year would thus be vital for Kiev. The resignation of the Ukraine's Prime Minister (December 2012) Azarov is mainly due to difficulty in renew negotiations on a loan from the IMF after the previous US\$15 billion loan was frozen. The departure of Azarov, who has opposed elimination of costly subsidies on household natural gas prices, a key IMF loan condition, should smooth the upcoming talks with IMF.

### In Belarus

Unlike Ukraine and Moldova, Belarus has never declared a desire to join the EU or to move toward a Western path of modernization. On the contrary, Belarus is unwilling to change, and its president, Alexander Lukashenko, "Europe's latest dictator", has shoved the country back into the worst of Soviet times. According to Freedom House, Belarus is a "consolidated autocracy", like Kazakhstan, Uzbekistan, and Turkmenistan. This explains why China's presence in Belarus is more consistent than in Ukraine. Because of the international ostracism, Belarus greatly needs to find economic partners besides Russia. The relations with the EU dramatically deteriorated with the strengthening of the use of repressive means following the protests against the reelection of Lukashenko in 2010. The EU Council decided in October 2011 to leave its restrictive measures in place until October 31, 2012, and to freeze the assets of and ban visas to 192 individuals responsible for the violations of international electoral standards in the presidential elections in 2006 and 2010 and for the crackdown on civil society and democratic opposition. Before the elections Lukashenko adopted a very generous social policy for securing himself a broad consensus. This system of consensus is however economically unsustainable unless, at least in the short term, external financing are flowing. For this reason, Lukashenko has intensified co-operation with China in order to gain cheap loans and investments. As Iwański points out, although Lukashenko is aware of the fact that relations

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<sup>13</sup> On the implication of the Kharkiv Accords see N. COPSEY - N. SHAPOVALOVA, *The Kharkiv Accords between Ukraine and Russia*, Wider Europe Working Paper, 6/2010.

with China will not outbalance Moscow's influence nevertheless he considers the partnership with Beijing important for showing that Minsk has some room for manoeuvre in foreign politics<sup>14</sup>. The Chinese wish to invest in Belarus might make more competitive any process of privatization (although the leadership is quite reticent on that) not leaving Russian as the only potential acquiring.

The economic situation of the country has severely deteriorated in the course of 2012. The Belarusian government has applied for an US\$8 billion loan from the IMF, but the Fund has demanded reforms in exchange. Belarus has then looked East with more appetite. China has given Belarus a loan of US\$1 billion and a grant of some US\$11 million. The Asian powerhouse will loan US\$1 billion in exchange for preferences for Chinese companies in acquiring shares in Belarusian industrial facilities (that is chemistry asset, energy housing). Together with a loan from the Eurasian Economic Community, thanks to Russia support, Belarus should be able to cover its current budget deficit. Minsk will borrow from the Chinese on favorable terms: the interest rate for the loan is estimated at 3%. Trade between the countries has increased: in 2011, China was the ninth largest recipient of Belarusian exports and the third largest exporter to Belarus. Belarus predominantly exports potash fertilizers to China (44% of total exports), and China exports mainly processed goods to Belarus. China and Ukraine have also announced that they will establish a joint industrial park<sup>15</sup>.

However, some tensions have recently surfaced. In April 2012, Belarus withdrew from the contract concerning the modernization of the Minsk airport because the Chinese partner had increased its value from US\$600 million to over US\$1 billion. Furthermore, a number of aspects of co-operation with China are beginning to give rise to public resistance. Residents of Smalyavichy near Minsk have protested against the construction of the industrial park, and the opposition and the independent media have made alarmist reports on the harm being inflicted on the country due to the increasing presence of Chinese capital. The 'China question' is thus becoming an element of dispute between the government and the opposition.

### In Moldova

In comparison to Ukraine and Belarus, Moldova's relations with China are less intense and developed. Moldova, contrary to the other two countries, is staunchly following the EU path. The EU and Moldova are currently negotiating an AA that should include a Comprehensive Free Trade Agreement as soon as Moldova will be ready to sustain the impact of far-reaching liberalization of its trade with the EU. Nevertheless, due to the poor economic conditions the country is searching for foreign investments and China is obviously an attractive investor.

In July 2009 a week before repeat parliamentary elections China signed an agreement to loan US\$1 billion (£600 million, €700 million) to Chisinau. Beijing's move came after Russia's agreement-in-principle to loan US\$500 million to Moldova and as payments from the US Millennium Challenge Account (MCA) have yet to reach US\$25 million. The Chinese loan is double the planned Russian credit and beats by US\$300 million the maximum that the MCA could offer. Moreover, the Chinese terms are highly favorable: a 3% annual rate over 15 years with a five-year grace period on interest payments. The money will be funneled through Covec, China's largest construction company. It will ostensibly be put towards infrastructure and projects such as energy modernization, water systems,

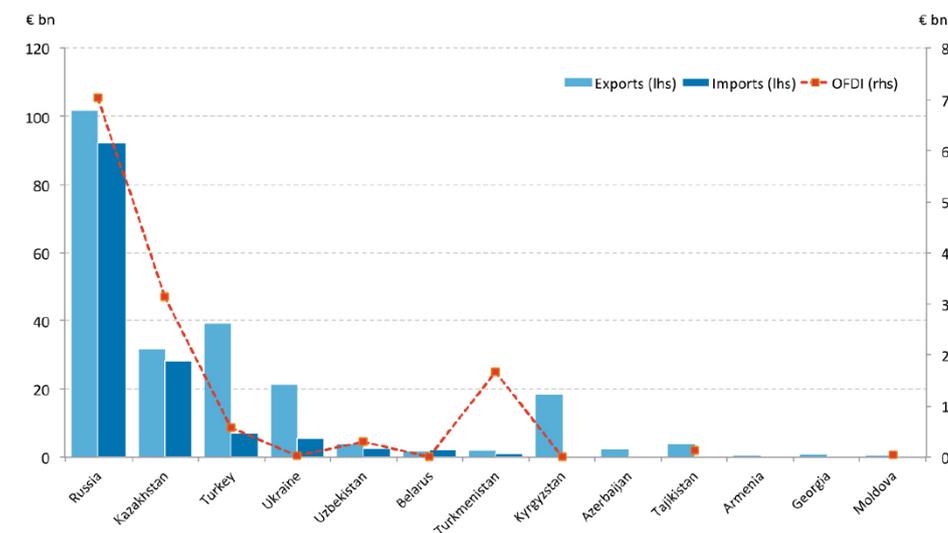
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<sup>14</sup> T. IWAŃSKI, *Ukraine, Belarus and Moldova and the Chinese economic expansion in Eastern Europe*, OSW Commentary, Warsaw, Centre for Eastern Studies, Issue 79, 29 May 2012, [http://www.osw.waw.pl/sites/default/files/commentary\\_79.pdf](http://www.osw.waw.pl/sites/default/files/commentary_79.pdf).

<sup>15</sup> «The China Times», <http://www.thechinatimes.com/online/2012/04/2997.html>.

treatment plants, the industrialization of agriculture and the creation of high-tech industries, which Moldova deeply needs<sup>16</sup>.

### China's trade with and outward FDI flows to the Greater Europe Zone States, 2005-2010 (€billion)<sup>17</sup>



Source: Comtrade, ChinaObs/FDImonitor

### Final remarks

It is primarily for economic reasons that China is interested in widening its presence in Eastern Europe. China has so far been moderately successful in boosting domestic demand though, on the one hand, its massive stimulus package and, on the other, by doing deals around the world aimed at increasing export and use Chinese expertise. Eastern European countries offer China a number of opportunities: low taxation regimes, relatively cheap and well prepared workforce, proximity to palatable markets such as the EU single market and the Common Economic Space. These countries see Beijing investments and capital as an opportunity to improve their overall economic situation and boost the modernization agenda. In comparison to Central Asian countries, Eastern European attitude about Chinese economic penetration is more relaxed. They are not geographically close and hence less worried about Chinese colonialist aspirations.

In political terms, Beijing's economic support can increase their bargaining power *vis-à-vis* Moscow while it provides a relief to those countries penalized by Brussels for not complying with its norms and conditions for deeper integration. China appears somewhat a third way in the intricate game between Russia and the EU. China's expansion is however more driven by economic pragmatism than for a desire to curtail Russia's role. On the contrary, in the short and medium term, the Chinese presence in Eastern Europe can even underpin Russia influence in the region. The economic support Beijing is providing in particular to Belarus and Ukraine is reinforcing these countries' Moscow-friendly leadership, to Brussels dismal. It helps perpetuating the Belarus autocratic regime and can compensate the EU recalcitrance to deepen the integration of Ukraine after the use of 'political justice' and the outcome of October 2012 legislative elections. This Chinese economic expansion *de facto* fits Russia' aspirations in the area. The only foreseeable conflict between Moscow and Beijing could be on energy even if outside Eastern Europe their national interests align.

<sup>16</sup> L. O'NEILL, *China is gaining a foothold in Russia's backyard*, «Ftchinese», 30 July 2009, www.ftchinese.com.

<sup>17</sup> T. APOTEKER, *op. cit.*, p.34.

China is offering Eastern European countries its rewards without asking for any political or social conditions. It is not a case that most of the loans granted by the Chinese leadership have come after a IMF's refusal of financial help. The low interest rate on the Moldova loan suggests that in implementing this project Beijing is more concerned about risk diversification and geo-political positioning than about returns. China's economic presence might also help avoiding conflicts between different and apparently opposite integration projects such as the EU and the Common Economic Space representing a bridge between two rival projects.

Chinese activism in Eastern Europe holds, however, some risks. The availability of the Chinese loans may contribute to the modernization of selected pieces of infrastructure without responding to a strategic plan of reforms. In the longer term, this might cause an increase in imports from China, including of machines weakening the heavy industry sector of these countries and increasing the level of their debts with unfavorable trade balance implications.

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