EURICS.
欧洲中国研究院 European Institute for Chinese Studies

n°23
June 2022

Briefs | Analyses

How Is the War in Ukraine Reshuffling the Cards for China?

The uncertain fate of the Iron Silk Road

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[EURICS fellow, Spring 2022]

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On February 4th, China's and Russia's state leaders Xi Jinping and Putin signed a comprehensive document paving the way for more intensive economic exchanges and celebrating an "unwavering friendship" between the two nations. Twenty days later, Russia invaded Ukraine, breaking international law and tearing down Europe's post-WWII peace order. The Russian aggression in Eastern Europe also clearly violates at least three out of the Five Principles of Peaceful Coexistence that have shaped China's external relations for decades: mutual respect for sovereignty and territorial integrity, mutual non-aggression, and peaceful coexistence—with non-interference in each other's internal affair as well as equality and mutual benefit constituting the remaining principles. Furthermore, the invasion has significant negative implications for China's economic interests in the Belt and Road Initiative (BRI) framework, along the Iron Silk Road in particular (i.e., the rail-based transport and industrial development corridor connecting China and Europe).

Still, Beijing has shied away from condemning the Russian aggression. Instead, it provided diplomatic support and spread a narrative that blames the "West" for having caused the conflict on official and social media. At the same time, however, China complies with the sanctions imposed by Western nations and refrains from providing Russia with extraordinary economic support. Chinese firms are not rushing into the Russian market to fill the investment and business vacuum retreating Western firms leave behind.

This ambiguity may be understood as a reflection of Beijing's struggle to navigate a course between Scylla—the demise of Putin's Russia and the rise of the USA to undisputed global dominance—and Charybdis—a massive extension of US technology sanctions against China blocking the country's further economic development. In this predicament, China's leaders know it will be impossible to simultaneously attain their various goals (domestic power politics, geostrategic aspirations, national economic growth, development imperatives…)

This contradictory situation is reflected in the fate of the Iron Silk Road. The Russian aggression deeply shook its foundations, but it has not yet stopped serving as a conduit for goods transport between China and Europe—albeit with lower volumes than before the war. At a higher level, the developments on the Iron Silk Road in the post-invasion era will ultimately shape the character and direction of the BRI as a whole.

All transport is disrupted but not stopped

Since its launch, the rail links between China and Europe have proved a successful logistics concept. Catering to a growing customer base that asks for reliable and fast transport at reasonable costs, the Iron Silk Road established itself as an integral feature of the European-China goods exchange. In 2021, 15 000 trains transported 1 456 million TEUs [Twenty-foot Equivalent Unit, equivalent to a 20-foot container or 38.5 cubic meters] on these routes between China and Europe. This transport channel's viability has been questioned with the Russian invasion of Ukraine. The current situation presents itself as follows:

All transport passing through Ukraine has been terminated due to military activities. As trains passing through Ukraine carried only about 2% of all Iron Silk Road transport volumes before the war, this shortfall is not decisive. However, China has lost access to its most important grain supplier (barley, corn, wheat) as not only railway connections have been disrupted, but the Ukrainian Black Sea ports—in which China had invested heavily in recent years—have been destroyed or blocked.

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All rail connections passing through Russia and Belarus—which carry the bulk of all containers between China and Europe—remain physically intact and operational. Still, transport volumes have been substantially reduced, with container turnover at the Iron Silk Road's terminal station Duisburg hovering at 50–60% of pre-war volumes. Western sanctions are one but not the primary cause of this development. Russian Railways RZD, which manages the underlying infrastructure and operates cargo services, is subjected to Western sanctions regarding its access to Western capital markets. Russian Railways has been the first Russian firm to go into technical default after failing to make a bond interest payment. But these sanctions do not forbid rail transport business from passing through Russia and Belarus in principle. However, payments for services rendered by Russian Railways pose a tricky management problem as most Russian banks are sanctioned and cannot be employed for such financial transactions. Rerouting such business processes via Chinese entities has proven a practical solution to overcome these hindrances.

No more high or low-value goods transported

The reason for the decline in transport volumes is, therefore, to be found at another level. In connection with the motivation to comply with values-based corporate social responsibility regimes and branding campaigns, ethical entrepreneurship is important for companies to break off their business relations with Russian players. Equally relevant, however, are security issues of transports passing through Russian territory. Particularly on the west-east route, containers used to be mostly filled with high-value goods (e.g., some trains were transporting nothing but German luxury cars). At present, theft of these goods on Russian territory would hardly be legally actionable. Even politically motivated seizures are conceivable and may become a reality. Given this constellation, any insurance coverage is not available. Therefore, the risk of having goods transported through Russia has become a significant and often prohibitive financial risk.

All of this could have led to a steady reduction in the volume of goods transported via the Iron Silk Road. Instead, a renewed increase in transport volumes has been observed in recent weeks. This was due to the congestion in Chinese ports caused by the zero-COVID lockdowns. With sea transport unavailable, numerous firms (manufacturers, forwarders, and carriers) were motivated to return to the Iron Silk Road and use its transport lines. This rebound may prove transient and dissipate with regular maritime shipping services resumption in the latter half of this year. In any case, the structural composition of goods transport has changed as high-value goods remain excluded, just as low-value goods that cannot cover the dramatically increased transport costs.

The short-lived Central Asian industrial hub

The Russian invasion of Ukraine has also exerted a fatal blow to Chinese aspirations to position itself as a technology leader and dominant market player in some new manufacturing hubs in Central Asia and—potentially—in new segments of the global value chains. Beyond promoting transit between China and Europe, Chinese actors became involved early on in establishing industrial and free trade zones at critical locations along the rail tracks. With these zones, investors could tap into local mineral, agricultural and human resources ("cheap" unskilled labor) and combine them with their own endowments of machinery and technology, management know-how, and global market experience. The manufactured goods were then exported along the Iron Silk Road to Chinese and European markets. This pattern mirrored the one that turned China's coastal provinces into the world's workbench during the 1980s and 1990s (there, too, foreign investors played a key role, catalyzing a process of rapid industrialization by leveraging underdeveloped local resources and introducing a mix of technology and export-oriented business models).

With the war in Ukraine, the duplication of this model in Central Asia is no longer feasible. The new sphere of industrial integration emerging under Chinese leadership is vanishing. All goods transport from Central Asia to Europe has stopped. Western investors are retreating from Central Asia and bringing their business activities in Russia and Belarus to an end. With this exodus, a central location factor is lost, and business models based on East-West connectivity are deprived of their fundamental business proposition. As a result, the massive investments by Chinese firms in these zones are compromised and often seriously devalued.

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The situation is further aggravated as the Asian Infrastructure Investment Bank (AIIB) and the New Development Bank (NDB) have stopped all new business in Russia and Belarus due to the arisen financial risks. With this move, these China-controlled investment banks adhere to Western sanctions. They also deal a blow to developing the above-described industrial fabric along the Iron Silk Road. Any investment activity to restructure local industry zone and infrastructure build-up in the post-invasion era has become even more difficult.

China's soft power impaired in Central Asia

The war-induced impairment of the Iron Silk Road also has the quality of a political pushback by Russia, which had not been happy with China's substantial build-up of economic as well as political influence in republics that were formerly part of the Soviet Union—and which Moscow seems to understand as its exclusive sphere of influence. As a result, China's soft power and capacity to project its interests in the region have been substantially scaled back.

In the years preceding the Russian invasion of Ukraine, the BRI, particularly the Chinese-led industrial and trade zones, represented the most important vehicle for disseminating Chinese regulatory ideas, business practices, and technical standards. De facto, a Chinese variant of "change through trade," had established itself. As their interaction with Chinese partners grew in intensity, local companies and regulatory bodies were increasingly incentivized to adopt Chinese institutions and regulatory structures. This could be observed in the spread of Chinese technology standards, e.g., in high-speed railway systems, "green" technologies, telecommunications hardware, and digital business models involving artificial intelligence.

At the macro level, there was a significant shift away from the U.S. dollar and the Euro to adopting the Chinese currency renminbi as an invoicing and reserve currency. This slowly emerging trend towards a stronger representation of Chinese ordering concepts in the global economic governance regime has now been interrupted—at least in Central Asia.

China's risk alleviation strategy undermined

The establishment of the Iron Silk Road also took place against the backdrop of efforts to free the Chinese economy from its one-sided dependence on maritime transport. Up to now, China's exchange with the global economy has been predominantly carried out by the sea. This applies both to the classic import and export of industrial goods as well as to the import of strategically essential resources such as energy carriers (oil, gas, etc.), raw materials (iron ore, coal, etc.), and staple foods (grain, soybeans, etc.). This structural feature would be unsuspicious if China were not in fundamental conflict with the U.S. (Thucydides Trap…) and if the global sea lanes were not unquestionably controlled and dominated by the naval forces of the latter.

Against this backdrop, the Iron Silk Road provides an opportunity to diversify supply routes for China's strategically essential imports and helps reduce China's geostrategic risks. With the detrimental impact of the Russian invasion of Ukraine on the Iron Silk Road, the realization of this option has been substantially impaired, and Beijing's geostrategic room for maneuver has shrunk again. Only the expectation of a significant expansion of Russia's overland exports of oil, gas, and grain dampens the adverse effects somewhat. However, a substantial increase in such supplies from Russia requires massive investment in new pipelines and other infrastructure facilities. Any notably positive effects will take years to materialize.

Alternative routing

Various transport routes bypassing the warring parties to the south are being explored to adjust to the current impairment of the Central Asian Iron Silk Road. Iran is also subjected to sanctions and off-limits for European firms, so all these southern routes must cross the Caspian Sea. In the Eastern direction, they run through Kazakhstan or Turkmenistan. In the Western direction, many existing transport lines pass from Azerbaijan through Georgia or Turkey to the Black Sea. After this second sea crossing, they enter the European Union via Romania or Bulgaria. Alternative routing leads through Turkey without a second shipping link. All these alternative transport routes involve significantly longer running times and higher costs. Bottlenecks exist in particular regarding the lack of infrastructure for transferring containers between wagons of different track widths: the rail networks of the economies involved are based on standard gauge (Europe, China) and broad gauge (former Soviet states).

Further restrictions arise from the lack of ferries for container transport on the Caspian Sea. In the summer of 2022, no more than three ships were in operation. The southern routes currently being explored to circumvent Russian territory will, by far, not be able to accommodate the pre-war transport volumes.

Regional re-orientation?

It can be surmised that neither the political-military impairments of the routes passing through Russia nor the infrastructure deficits of the southern routes can be solved in the foreseeable future. As a consequence, a regional shift in production and supply relationships to the detriment of China may come into motion. On the one hand, such a development would only reinforce trends already set in motion by European firms. An increasing number of European firms perceive the political risks of doing business with and in China as having become more significant in recent years and regard the zero-lockdown measures of the Chinese government as obstructive. For example, according to a German Institute for Economic Research survey, almost 50% of the participating German companies plan to reduce their procurement activities in the Chinese market.

On the other hand, such a regional shift would take up Chinese policy initiatives that pro-actively strive to relocate low-productivity manufacturing out of China into less developed BRI-partner countries. With Central Asia no longer presenting a viable option for such industry relocation, one should expect a further strengthening of related BRI policies in Africa and South-East Asia. Especially the latter may become a preferred new manufacturing hub as the Regional Comprehensive Economic Partnership (RCEP) takes shape.

A long-term reorganization of economic interactions

The BRI may be understood as the international projection of Xi Jinping's "China Dream" designed to strengthen the Chinese economy and project Chinese power and influence globally. With the Russian invasion of Ukraine and the ensuing aggravation of East-West relations, the implementation of this strategy has experienced a severe setback, the full consequences of which cannot yet be ascertained. However, one thing is sure: with Beijing's (verbal) support of the Putin regime, the perception of China by the Western industrialized countries has become even more negative. It is expected that the EU will confront Chinese attempts to anchor its interests in Eastern Europe and elsewhere more resolutely. At the same time, initiatives to curtail BRI-based influence over third countries are likely to intensify. Programs such as the EU's Global Gateway Strategy and the G7's Build Back Better World (B3W) are expected to be pursued with renewed vigor.

The long-term impairment of the Iron Silk Road may lead to far-reaching changes in the structure of global economic interaction triggering a redirection of investment and trade flows. It might also lead to a reconfiguration of the globe's industrial gravitation centers. The Iron Silk Road risks losing a significant part of its transnational character and atrophy into a mere facilitator of bilateral Sino-Russian trade. The latter can surge in the coming months and years as Russia becomes increasingly dependent on Chinese technology supplies and upmarket consumer goods. It will have to pay for these with mineral resources, oil, and gas. However, there will be strict limits to the intensity of this exchange. Chinese authorities will be cautious and restrict the technology content of its exports to Russia to avoid violating the U.S. Foreign Product Direct Rule and other sanctioning policies that would trigger further painful sanctions against China. The collateral damage to the BRI and the overall costs arising from the Russian invasion of Ukraine is already high enough for Beijing.

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