

# Research Reports

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## The Trap of Escaping Dependence on Russia: Europe and Russia's Dependence on China

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### 1. Effects and side effects of economic sanctions in a multipolar era

Countries led by the G7 are constructing and strengthening multidimensional network of economic sanctions against Russia, including the inclusion of Russian nationals on the US Specially Designated Nationals and Blocked Persons List (SDN List), the exclusion of major Russian banks from the Society for Worldwide Interbank Financial Telecommunications network(SWIFT), the embargo of resource-related technologies and services, and bans on coal and crude oil imports and on tanker transport insurance. These measures have severely impacted the Russian economy. However, the IMF revised its real GDP growth forecast for Russia in 2022 upward from -8.5% in April to -6.0% on July 26, 2022. This revision was based on Russia's monetary and fiscal policies and oil and gas export revenues<sup>1</sup>.

The first half of 2022 saw a trade surplus of \$138.5 billion for Russia, and the ruble, which had plunged for a time, has since recovered<sup>2</sup>. Nevertheless, it is not always appropriate to argue that "huge cash inflows have helped the Kremlin weather sanctions pain." Economic sanctions prevent Russia from

using dollars and euros to finance its war or to buy goods and services required for economic activity, even if it gains access to these currencies through the export of resources. Moreover, given that Russian oil and gas development has previously relied on Western technology and software, the withdrawal of BP, Shell, Exxon, and three major US resource-related service companies (i.e., Baker Hughes, Schlumberger, and Halliburton) may even result in a long-term decline<sup>3</sup>.

Nonetheless, Russia demanded ruble-denominated settlements for gaseous natural gas (i.e., pipeline gas) and cut off supplies to Poland, Bulgaria, Finland, the Netherlands, Denmark, and Latvia when they failed to comply. Furthermore, supply via Nord Stream 1 (the pipeline that directly connects Russia and Germany and accounts for one-third of the gas supply from Russia to Europe) was halted, citing economic sanctions against periodic turbine inspections and maintenance. Although supply has resumed, it has remained at 20% of normal levels<sup>4</sup>.

The European Union (EU) is facing a quadruple whammy of soaring energy and food prices, a trade deficit, a weak euro, and a gas crisis due to the sanctions against Russia. In June, the eurozone inflation rate exceeded 8.5%. In May 2022, the EU's monthly trade balance, which had shown a surplus of 20 billion euros the previous year, fell to a deficit of 35 billion euros; in July, the euro dropped below parity against the dollar for the first time in 20 years. Moreover, replenishing gas stockpiles to 90% by October will be difficult, forcing the EU to reduce gas consumption by 15%.

It should be recalled that despite deepening market integration, the EU has failed to overcome severe economic disparities and energy deprivation; thus, failing to become a model of "shared prosperity."<sup>5</sup> Even in 2019, prior to the COVID-19 crisis, the proportion of working poor in the EU was 9%, with double-digit figures in many countries (e.g., Romania, 16%; Greece, 13%; Spain, 13%; Italy, 12%). Those with lower incomes bear the brunt of the side effects of the sanctions, which could lead to social unrest and political instability, impacting domestic and international politics within the EU and undermining its solidarity.

The economic sanctions against Russia are deteriorating. At the G20 Foreign Ministers' Meeting in July 2022, the differences between the G7 and emerging economies that oppose sanctions became evident. Meanwhile, Iran submitted a BRICS membership application, following an extended meeting in June attended by 13 emerging economies. Despite the risk of secondary sanctions, China and India have maintained their regular commercial transactions policy and increased their crude oil and natural gas imports from Russia. Similarly, Turkey has agreed to expand trade with Russia.

Behind this is the reality of multipolarity: according to the IMF, the G7 countries accounted for more than half of the world's GDP (purchasing power parity) prior to the dissolution of the Soviet Union in 1991, but they now account for less than a third. This is nearly equivalent to the combined GDP of China, India, and ASEAN countries.

## **2. The accelerating "European Green Deal" and its bottlenecks-the issue of transition pathways to decarbonization<sup>6</sup>**

The EU's ambitious European Green Deal, which it unveiled as a growth strategy at the end of 2019, aims to establish internal EU regulations that integrate sustainability into the process of capital accumulation through taxonomies (classification criteria for sustainable economic activities) and other measures. It also aims to open the frontiers of green business by making the European standard a global one and using it as a growth opportunity for EU industry. In response to the COVID-19 crisis, the European Green Deal was launched in 2020, which was supported for the first time by a €750 billion recovery fund backed by EU common bonds. In 2021 a series of strengthening measures known as "Fit for 55" were presented, including the Carbon Border Adjustment Mechanism and a de facto ban on the sale of internal combustion engine vehicles by 2035.

However, to achieve climate neutrality by 2050, the transition pathways for decarbonizing the entire value chain must be clarified while taking into account the realities of all industries that rely on fossil fuels. The EU thus launched "A New Industrial Strategy for Europe -Green and Digital Transition" in 2020 as a concrete measure for the European Green Deal. According to this, the green and digital transition "will take place in a time of moving geopolitical plates which affect the nature of competition. The need for Europe to affirm its voice, uphold its values, and fight for a level playing field is more important than ever. This is about Europe's sovereignty." This appears to be a preview of what was to come. The European Commission has stated that it intends to strengthen public-private partnerships, such as the Battery Alliance and the Clean Hydrogen Alliance, and to increase industrial support for climate neutrality across the board.

However, the market was alarmed by the launch of "Fit for 55" in the midst of uncertainty about the new industrial strategy's direction, which was still in its early trials. With a surge in energy demand due to the recovery from the COVID-19 crisis, frequent problems involving liquefied natural gas (LNG) and a 20% decrease in gas stockpiles from the previous year due to higher gas demand driven by a shortage of wind power, and speculation in gas futures in the autumn of 2021 triggered a surge in gas prices, which had long been stable at low levels. In other words, the European Green Deal failed to establish a transition path for industrial decarbonization and may have contributed to the autumn 2021 gas price spike.

## **3. "REPowerEU" as a means of escaping dependence on Russia/fossil fuels, and a new dependence**

In addition to the aforementioned, the war in Ukraine posed a geostrategic threat. In May 2022, the EU announced a plan titled "REPowerEU" to break free of dependence on Russia in a short time.

According to this plan, the EU intends to secure alternative energy sources, particularly LNG, to replace the Russian supply in the short term while promoting energy efficiency and increasing investment in solar and wind power in the medium term and enhancing hydrogen production using renewable electricity after 2027.

However, obtaining an alternative source for the 155 billion m<sup>3</sup> of natural gas that Russia has been supplying to Europe will be difficult, and the price may be ten or more times higher. The EU-US Joint Declaration on European Energy Security was released on March 25, 2022. The document states that the US "will strive to ensure" a supply of 15 billion m<sup>3</sup> of LNG in 2022, significantly less than the 18.7 billion m<sup>3</sup> it provided in 2020. LNG exports from the US to Europe are indeed beginning to increase under the current conditions, but this is due to Europe's high LNG prices. According to trade data, the destination of US LNG varies based on price trends; if the price is higher in Asia, the LNG will go there because, of course, this is business, not politics<sup>7</sup>. Moreover, LNG receiving terminals in well-connected northwestern Europe are operating at full capacity, leaving little room for additional imports. Building new LNG terminals and associated infrastructure is an expensive and time-consuming endeavor<sup>8</sup>. In June, the EU and Norway agreed on additional natural gas supplies. In July, the EU signed a memorandum of understanding to increase Azerbaijan's natural gas exports from 8 billion m<sup>3</sup> per year to 20 billion m<sup>3</sup> by 2027. However, this will necessitate investments in the South Gas Corridor's infrastructure.

According to the IEA, even if these measures to diversify supply sources are successful, supply will remain insufficient, and it will be necessary to curb demand. Other options, including extending the operation of coal-fired and nuclear power plants, are also considered.

Even if the EU can weather the gas crisis with the aforementioned short-term measures, it will have to rely on expensive LNG imports for the foreseeable future.

#### **4. Economic security -green and digital transitions depend on metal and mineral resources**

The decarbonization of economic activity must be accelerated and the "Fit for 55" scenario must be realized well ahead of schedule to break away from dependence on LNG. Thus, significant investments in renewable energy and clean hydrogen<sup>9</sup> are being proposed as medium- to long-term measures in "REPowerEU."

However, metal and mineral resources are needed to develop machinery, equipment, and infrastructure for using renewable energies, such as solar panels, rechargeable batteries, generators, motors, electric vehicles, as well as recharging and hydrogen stations. Rare earths and other critical raw materials (CRMs), which are scarce mineral resources, are essential for green and digital technologies, which are crucial to realizing the European Green Deal. However, the geographic

distribution of their supply sources is quite uneven, and there is already some competition for these resources. Even the prices of nickel, cobalt, lithium, aluminum, and copper are expected to rise over the long term at double-digit average annual growth rates<sup>10</sup>. Furthermore, the war in Ukraine is making metal and mineral resources even more scarce.

When it comes to CRMs suppliers designated by the EU, China accounts for 44% of supply (2016-2018). In 2021, the European Commission updated its previous year's new industrial strategy, stating that it must collaborate with industry, public authorities, social partners, and other stakeholders to cocreate green and digital transition pathways for each industrial sector, and that it will strengthen industry-academia-government collaboration in six areas: raw materials, batteries, active pharmaceutical ingredients, hydrogen, semiconductors, and cutting-edge cloud-related technologies. This is due to the fact that 137 of the 5,200 products examined by the Commission were highly import-dependent and had a significant impact. Moreover, a breakdown shows that China accounted for 52% of these, Vietnam 11%, Brazil 5%, and South Korea 4%, while the US, UK, and Japan each accounted for only 3%. In other words, the EU's efforts to reduce its reliance on Russia by accelerating its green and digital transitions risk increasing its reliance on Chinese resources and technology.

That is why, in 2021, the European Commission launched a new trade policy-"Trade Policy Review An Open, Sustainable and Assertive Trade Policy"-as a measure to support the new industrial policy from the foreign policy side by emphasizing "open strategic autonomy."

## **5. Russia's shift to the East: from dependence on Germany to dependence on China<sup>11</sup>**

Despite Russian President Vladimir Putin's displeasure with NATO expansion at the 2007 Munich Security Conference, the Bucharest NATO Summit Communiqué in the following year stated that Ukraine and Georgia "will become NATO members." In 2006 and 2009, Ukraine-Russia gas pipeline disputes also arose.

Russia's shift to the east began to materialize around this time. Russia began construction of the East Siberia-Pacific Ocean (ESPO) oil pipeline in 2006, and the Daqing branch line was completed in 2010, and the entire ESPO line became operational in 2012, paving the way for the export of approximately 25% of Russia's oil to Asia. In 2009, LNG exports from Sakhalin II also began. In May 2014, China and Russia signed a 30-year supply contract for up to 38 billion m<sup>3</sup> of gas, and the pipeline to carry it-Power of Siberia-began operations in 2019. Economic sanctions imposed in 2014 in response to the Ukraine crisis and annexation of Crimea allowed Russia to strengthen its economic ties with China further.

China accounts for just under 20% of Russia's trade at present. However, note that China has surpassed Germany as the largest importer of mineral resources from Russia and the largest exporter of industrial machinery, equipment, and semiconductors to Russia over the past 20 years. Due to severe economic sanctions, Russia has no option but to increase its reliance on China. Russia's move to dedollarize and seek an alternative market to Europe is in China's interest, as it needs inexpensive and stable energy to replace coal and internationalize the renminbi.

## Conclusion

The war in Ukraine, the resulting G7-led economic sanctions against Russia, and efforts to reduce European reliance on Russia will increase the likelihood of Europe and Russia's dependence on China. The EU must develop industry-specific decarbonization transition pathways to reap the benefits of an open global economy while avoiding new dependency risks. Moreover, the entire supply chain must be reviewed, taking into account the risks of reliance on strategic technology and resources, to increase European industry's strategic autonomy and strengthen economic security<sup>12</sup>. This is the economic justification for deepening EU-Japan cooperation based on "open strategic autonomy."

However, in a multipolar world in which both the EU and Japan are losing ground in the global economy while emerging economies, such as the BRICS, are rising, the EU's "ability to make its own choices and shape the world around it through leadership and engagement, reflecting its strategic interests and values," as assumed by the new EU trade policy, has natural limits, and thus the specific form of "open strategic autonomy" will likely need to be redefined.

The fate of the EU-China Comprehensive Agreement on Investment (CAI) will be the touchstone for "open strategic autonomy." Although the CAI was broadly agreed to at the end of 2021, the European Parliament has refused to discuss it, but the fact that European industry welcomed it should not be overlooked.

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<sup>1</sup> [IMF, World Economic Outlook Update - Gloomy and More Uncertain, July 2022.](#)

<sup>2</sup> [Bloomberg, Russia Current Account Hits Record on Surging Energy Export, July 11, 2022, updated on July 12, 2022.](#)

<sup>3</sup> [James Henderson, Thoughts on the impact of foreign companies exiting the Russian oil and gas industry, OIES, Energy Insight: 112, March 2022.](#)

<sup>4</sup> [Bundesnetzagentur, Gas supply status report at 1 pm, August 12, 2022.](#)

<sup>5</sup> See my article "Trade, Finance and Social Problems: Economic Globalization and International Organization," Katsuhiko Shoji (ed.), *International Organization (New Edition)*, Iwanami Shoten, 2021.

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<sup>6</sup> See my article "The Bottleneck of the European Green Deal," *World Economic Review*, 2022, 66(2), Bunshindo; and "The EU New Industrial Strategy: Linkages between Industry, Energy Environment, and Trade," *Foreign Investment and Financing*, Japan Institute for Overseas Investment, 2021, 30(5).

<sup>7</sup> [See my article, "The European Green Deal and Economic Security: The Long-Term Impact of Russia's Invasion of Ukraine," \*Report of Institute of Eurasian Studies\*, 2022, No. 137.](#)

<sup>8</sup> [Yutaka Shirakawa, "The Latest Trends in Natural Gas and LNG: The LNG Market Wave is High! Will Spring Come for Gas in a World Shaken by Great Power Ambitions?," \*Oil and Natural Gas Review\*, 2022, 56\(3\).](#)

<sup>9</sup> [For more on hydrogen, see my article, "EU's Hydrogen Strategies Being Advanced in the Face of a Quadruple Whammy," \*World Economic Review IMPACT\*, 2022, No. 2629.](#)

<sup>10</sup> [ING, \*Electric vehicles to drive metals demand higher\*, Economic and Finance Analysis, October 13, 2021.](#)

<sup>11</sup> According to my article, "The Ukraine War and China-Russia Economic Relations," *CISTEC Journal*, Center for Information on Security Trade Control, Japan, 2022, No. 199.

<sup>12</sup> However, discussions on economic security tend to focus on securing advanced technologies, overlooking the fact that digitalization and green technology create a large amount of "waste" such as used batteries. The realization of the EU's Circular Economy policy, which aims to create a commercial flow to produce and utilize high-quality secondary raw materials from "waste," could be the ultimate economic security that could reduce dependence on foreign resources. [See my article, "The EU's New Resource Dependence Risks and the Circular Economy," \*World Economic Review IMPACT\*, 2022, No. 2500.](#) Appendix: This paper is part of the research results achieved with a Global Environment Research Grant from Ichimura Foundation for New Technology.