

The Institute for Statecraft

CONFIDENTIAL

China's Strategy towards Europe:

Implications and Policy Recommendations
for EU Security

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1. Executive Summary

For the better part of two centuries, the dominant global system has been shaped by Western culture and values. International economic and financial institutions set up by Western powers reflect Western interests over those of developing countries. Through its efforts, the West has succeeded in influencing in its own favour the global political, economic, social and cultural environment within which the world's states, corporations and institutions and movements today compete vigorously for their place.

China is not seeking to find its place in this world system, China is determined to establish its place in the world on its own terms, to create an alternative system with different cultural values to challenge the hegemony of the Western system. China is pursuing this policy with a truly strategic approach; that is, not only with focus, coherence and determination, but also on such a global scale that China can hope thereby to change the global environment to favour itself and those countries which prefer the Chinese model to the current Western one. This is truly grand strategy, and China is demonstrating that it is adept at this, quick to learn and adapt.

A study of China's strategy and tactics shows that China understand very well the *hypercompetition* that characterises today's world and that, in this hypercompetition, states and other actors need to be able to employ many different kinds of power to succeed. Military power is still important, but it is by no means the only, or dominant, form of power. China is also demonstrating that it understands and can master the many forms of power and use them appropriately.

In its relationship with the EU – a major player in the global system – China's strategy can now be clearly discerned. China has gone to great pains over the last two decades or so to study the EU and to identify what the EU has to offer China. As a result, China has been able to structure its approach to the EU in a way which maximises the benefit China gets from the relationship, whilst minimising the impact of EU culture, values and practices on China except in those cases where those practices might advance China's interests.

As an organisation still very much in development, the EU, whilst large and strong, has not yet developed all the mechanisms and skills it would need to turn its latent strength into real, effective power. Strategic thinking within the EU, such as it has been, has been devoted to developing the organisation's internal structure and functions and to the sharing of competencies and responsibilities between the central organs and with the member States. The EU has not yet developed adequate mechanisms or the teams of qualified people needed to enable it to think and act strategically in its external relations.

China understands this very well. In the EU-China relationship, China is acting strategically; the EU is not, neither are many of its Member States. As a result, the EU is being systematically out-thought and outmanoeuvred by China. The respect which China used to show the EU is being replaced by contempt on account of the EU's perceived powerlessness. China is using the differences and disagreements between Member States to "divide and rule". Through its carefully targeted investment strategy, focusing particularly on strategic industries and infrastructure, China is able to take full advantage of Member States' need for or greed for money, exacerbated by the recent,

ongoing, financial crisis in the West. Most Member States and EU institutions, preoccupied as they are with their own internal problems, see only what pertains to them of Chinese actions. Because they themselves are not thinking or acting strategically, they do not see the big picture. They do not recognise Chinese strategy for what it is.

The whole ethos of the EU is that of an organisation to which States adhere or aspire on the basis of their voluntarily signing up to what amounts to a code of values, standards and practices. All the EU's internally focused grand strategic actions are inspired by this all-pervasive philosophy. The Partnership and Cooperation Agreements, for example, are designed to provide incentives, help and encouragement as States strive to adapt themselves to meet these, often demanding, rules so that their relationship with the EU can develop based on the mutual trust and respect that the voluntary adherence to a set of rules based on shared values and standards can bring.

The EU's relationship with China was begun in much the same spirit, motivated by the conviction that China would naturally "want to be like us". The relationship to date has been characterised by the EU's offering a developing China access to the benefits of the EU unconditionally, engaging in trade without demanding reciprocity, accepting an asymmetrical relationship which opens the EU to Chinese companies but closes off large sectors of China to EU companies. It is hardly surprising that the EU is now seen as a resource that China can milk to develop its economy.

Not only have these well-meant blandishments failed in their purpose, but it is becoming ever clearer from China's actions that they will continue to fail if they are persevered with, to the detriment of the interests of the EU and of its Member States. Indeed, in the face of all the evidence now available, for the EU to persevere with these recent policies would show that this benign EU philosophy had become a blind ideology. China does not want to be like the EU. It will not reshape itself in the EU's image. In every facet of the relationship, be it in the legal investment strategy China is pursuing, in the "divide and rule" tactics towards the Member States, or in the activities of Chinese organised crime within the EU, there is complete consistency of approach. Far from China learning to work by the EU's rules, China is trying and will continue to try to evade those rules. China has its own set of rules to work by.

This is the practical demonstration of a different culture. Western traders with China have understood this reality for centuries. Those who have learned to cope with it and adapt have profited enormously. Those who have not have failed, and have been swept away. The EU now has to learn to cope with this reality. To deal satisfactorily with China so that the relationship can be stable, harmonious and mutually beneficial, the EU must develop an ability to think and act strategically. There are no tactical or procedural solutions.

Detailed Policy Recommendations are given in the final section of this study. A brief précis of the main points of those recommendations is as follows:

EU Institutions

1. Create an informal strategy group within the EEAS, drawing on existing resources of talent. Develop this as a basis for a formal group.

2. Make a prior “impact assessment” of significant actions to be taken by all European Commission services.
3. Engage EEAS and Commission research instruments to undertake essential research on all key issues relating to EU security and China
4. Create a Forum of Asia-Pacific States, on the lines of NATO’s instruments for dialogue and cooperation, to discuss issues of regional security and cooperation.

Chinese Relations with Member States

1. Monitor and regulate Chinese engagement with ad-hoc groups of Member States.
2. Find solutions at the EU level for the smaller EU Member States concerning their relations with China.
3. Ask Member States to inform the EEAS and each other of their contacts with China
4. Monitor Chinese immigrant communities in Member States.

Resources

1. Boost investment in energy efficiency research to reduce supply dependency.
2. Develop second and third generation technology which does not require back up fossil fuel power generation.
3. Develop shale gas resources to reduce European supply dependency.
4. Support the development of offshore resources in the Eastern Mediterranean region.
5. Support methane hydrates research as a source of significant future energy resources
6. Investing in natural gas vehicle technology to reduce supply dependence.
7. Build an Energy/Resource Relationship with Japan.
8. Identify those natural resources that raise the most significant supply security issues and design a substitution research programme around them.

Finance and Investment

1. Establish a centre within the EEAS to work with Member States to monitor and analyse Chinese investments and to disseminate information and engage in education on this topic
2. Improve legislation to close loopholes which allow China to operate unlicensed and unregulated financial institutions.
3. Establish a single system and a common accounting process for Member States to record foreign holders of public debt

Infrastructure

1. Initiate a study with Member States to establish a common minimum definition of the principal elements of national security and what constitutes critical national infrastructure and critical areas of their economy and society.
2. Publish assessed minimum standards (Red Lines) for ensuring that Member States maintain control of their critical infrastructure and economic assets.
3. Monitor especially Chinese investment in and acquisition of Member States infrastructure, supply chains and critical areas of their economy.

Trade

1. Press the Chinese authorities to be transparent about the ownership, composition and financing of all major corporations wishing to work in the EU.
2. Establish a process of reciprocity to compel China to open its markets to EU participation.
3. Work with Member States to improve the level of understanding, in governmental departments and in the corporate world, of Chinese policy, strategy and tactics.

Defence

1. Improve research into Chinese military developments, capabilities and capacities, and into Chinese defence exports and defence diplomacy (e.g. exercises with third party countries)
2. Sponsor seminars and workshops with Chinese defence experts to improve mutual understanding and confidence-building.

Law Enforcement

1. Strengthen Europol's capacity to support Member States' monitoring of internet sites advertising counterfeit goods and other products of Chinese organised crime.
2. Enable Europol to negotiate an agreement with China to track down and bring to justice those ringleaders of organised crime in Europe who are based in China.
3. Reinforce the European Cybercrime Centre to raise awareness and to support investigations in the Member States.
4. Increase the number of interpreters for Chinese languages and enable their sharing across the EU.
5. Encourage Member States to improve intelligence gathering on Chinese crime and to share the results
6. Improve cooperation with the Chinese authorities.
7. Improve European legislation on illegal drugs and counterfeit goods to enable more effective enforcement and prevent evasion of the laws.

Cyber

1. Establish an EU equivalent of the NATO centre of excellence in cyber. Resource it to monitor cyber incidents, establish an EU code of practice and agree a common approach to cybercrime
2. Improve legislation to make reporting of cyber incidents and risk assessments of the vulnerabilities of critical national infrastructure obligatory by Member States.
3. Modify the Framework R&D programme to prioritise cyber;
 - a. Sponsor a comprehensive, technical research process and educate a new generation of “cyber warriors”.
 - b. Sponsor work on defensive IT measures on a large scale.
4. Sponsor the EU to create a new, alternative web.
5. Publish *Red Lines* to help Member States check Chinese actions, beyond which national and EU interests would be damaged.
6. Co-ordinate between Member States.

Education

1. Encourage Member States’ reporting of Chinese educational initiatives, funding and conditions demanded, e.g. for establishing Confucius Institutes and language courses.
2. Monitor Chinese take-up of courses in Member States and publish details.
3. Sponsor the study and monitoring of Chinese global commercial, political and social activity. Generate a “China Studies” community amongst Member States.

1. Introduction

This Report provides an explanation of Chinese actions and intentions as they impact upon the EU so that the EU can develop its own effective actions towards China, enabling relations to develop more harmoniously between the two entities. For, if the EU and China continue on their current trajectories, future relations will be anything but harmonious.

In the preparation of the Report, the authors met with representatives of the European External Action Service, of the European Commission and of Europol. The authors drew on published sources and on interviews with individuals in Member State institutions, as well as with independent experts, academics and practitioners, including some resident in China. The conclusions drawn, however, are entirely the authors' own. The team leader, who has prepared and edited the Report, takes full responsibility for all errors and omissions.

This Report, firstly, proposes a possible way of thinking about China and about the social phenomena involved. This way of thinking must be shared with and understood both by the Member States and by the EU institutions if effective actions are to emerge. It will help a great deal if our understanding and actions are matched by our allies.

Secondly, this Report examines Chinese actions and assesses the impact of Chinese strategy and tactics on Europe. It suggests how the mechanisms available to the EU to respond to this challenge might best be used, and what new or amended mechanisms are needed. In its recommendations, the Report also suggests ways in which EU Institutions might begin to compensate for any lack of political will on the part of, or conflict of interests between, Member States.

Thirdly, this Report highlights what we consider it essential for the EU to do to protect its internal security and the interests of the Member States. Tactical actions can never be an answer in themselves, but at least they can create a baseline from behind which the EU can develop its statecraft, formulate policies, and develop a process to build a grand strategy. Only such a grand strategy will enable the EU to advance the collective interests of its Member States and develop a harmonious, mutually advantageous relationship with China.

The recommendations are made throughout the text, and specific, detailed recommendations are to be found in the final section of the report. These recommendations are given in a real spirit of humility, knowing as we do how very hard it is to get things done in a multi-national environment. However, difficult is not impossible. To quote Confucius: *"When it is obvious that the goals cannot be reached, do not adjust the goals; adjust the steps taken to achieve them"*.

There are three issues fundamental to our being able to deal with China which must be thoroughly understood before we even begin to assess the Chinese position. These are:

- the nature of strategy and grand strategy
- the phenomenon of hypercompetition
- the concept of security.

Strategy, *competition* and *security* are English words in constant use within the EU. Yet, in the preparation of this Report, we have found such wide variations in understanding as to their meaning that it is essential that we begin the Report with an explanation and a definition of these key

concepts. Indeed, striving for a common understanding and an agreed definition of these concepts across the Member States, taking account of the nuances of their different languages, cultures and histories, has emerged from our Study as one of the most urgent educational tasks for the EU to undertake.

With these concepts clearly laid out, the Report then addresses the factors that have shaped Chinese policy towards the EU and the strategy and tactics by which China seeks to implement that policy. Establishing the facts of the tactics has been less difficult than anticipated - there is far less dispute about those facts than might have been expected from so many different countries and institutions. *Determining the intent* of the policy and strategy is a far more contentious issue, requiring a greater exercise of judgement based on the knowledge and experience of the individuals contributing to the Report. This has underlined the importance of understanding China as it is, rather than as we would like it to be; of seeing circumstances and events through Chinese eyes, rather than through our own (which, given the diversity amongst Member States, is already a very wide canvas).

It has specifically not been the task of this report to devote much of its limited resources to an assessment of what makes China what it is and what gives the country its special culture. A very great deal of intellectual effort is devoted to this topic elsewhere. But we have thought it essential to sketch out those features which we consider to be the defining elements of the Chinese understanding of security and strategy.

In understanding how the EU might best respond to Chinese actions, and might best develop a proactive strategy so as to ensure a harmonious and mutually beneficial relationship, the Report has been similarly constrained. It has not been possible to go into detail on all issues. We have concentrated on several important or high-profile issues as examples which demonstrate key principles. These principles, we would argue, provide a firm basis for future research, discussion, debate and action on a wide range of issues.

On the issues addressed in this report, which are fundamental to the future of the EU and to the prosperity and security of its Member States, it is no longer acceptable to say: "This issue is not within the competence of the Commission" or "There is no agreement on this issue between the Member States". Those statements may be true, but they can be no excuse for inaction. Confucius again: "*To see the right and not to do it is cowardice*". Identifying the gaps or inadequacies within the system must be merely the first step in remedying those inadequacies and filling the gaps. It has become clear in the preparation of this Report that, notwithstanding the acknowledged limitations of the EU systems, much more can be done within existing constraints and with existing resources. Our recommendations will draw out examples of some of these opportunities.

Throughout this Report we have attempted to be as objective and dispassionate as possible when assessing the Chinese actions and determining their intent. To be judgemental about an issue, to say that: "the Chinese are wrong to do this", or that: "it is not legitimate for them to do this", seems to us to be futile. The Chinese understanding of law, and therefore what constitutes legitimacy, is very different in many of its aspects from what we in Europe understand. If we always assess Chinese actions on the basis solely of our own cultural assumptions and convictions there will be no meeting of minds, only constant conflict.

This does not mean that the EU should not pursue what it perceives to be its own interests and advance the causes of its Member States- quite the contrary. But this in turn presupposes that the EU knows what these interests are and can assess how they will be best served. It also requires that the EU can correctly determine how China perceives its interests in the same case so that any potential clash of interests can be defused before it turns to conflict. This is the very essence of a grand strategic approach. The need for the EU to improve its ability in this area is the main conclusion of this Report.

2. The Importance of Strategy

Understanding strategy is one of the keys to understanding the security relationship between the EU and China. But there is a problem with the terminology which must be clarified if this concept is to be properly understood and used effectively by the EU.

Until relatively recently, the word strategy was used only in a military or a national/ international affairs context. Strategy was an essential tool - and the ability to think and act strategically an essential attribute - for coping with the complexity of war. But the expansion, over the past fifty years, of the use of the word "strategy" (and its equivalent in different European languages) so that it can now be applied to any topic at all, has diluted the meaning of the term and obscured its fundamental significance. Even in governments, the understanding of "Strategy" has become blurred because in many Member States they have lost the arts of Strategy Making and Strategic Thinking.

We need to recognise that there is no quick, simple solution to the complex problems which now beset the EU, not the least of which is the development of a safe, mutually beneficial relationship with China. To resolve these problems will require the EU to provide itself with the capability for strategic thinking and acting.

'Strategy' and 'Strategic thinking' are qualities of statecraft. Once the EU has determined its policy in relation to China, that policy must be implemented through strategy. The term "strategy" describes the art of engaging at a high level of scale or responsibility with a live and vigorous opponent. The concept implies constant interaction. "Grand Strategy" considers the interaction between states at the highest level of scale.

Strategy must take into consideration the impact of the environment in which the engagement takes place and any allies or neutral parties, as well as considerations of the main protagonists. To confuse this way of thinking and acting with 'a strategy' - i.e. to focus only on 'a strategy' as a document or fixed plan, a series of actions, however thorough and detailed - would be a disastrous mistake. It would be to fail to recognise the all-important fact that strategy is constantly evolving. To succeed, it must be forward-thinking, innovative, creative, constantly changing, continuously or discontinuously. Strategic thinking must not be merely reacting to changing circumstances and unforeseen challenges, it must try to foresee the possible nature of those challenges and forestall them.

To be able to employ strategy and grand strategy, to think and act strategically, requires an institution (in this case the EU) to have a group of individuals with the competence and authority, formally or informally, to produce and implement that strategy. In some circumstances, countries and institutions can think and act strategically without formalising the process. If the leadership are well educated, understand the situation in a similar way, have a clear understanding of their interests, and can take action when necessary, the result can be real strategy.

Whether formal or informal, the people who do, or who are tasked to do, strategy require a deep knowledge and understanding - of the environment, of the players (i.e. the EU, Member States and China) and of current events and circumstances. These people should possess strong intellectual ability coupled with an agility and flexibility of mind. Strategy also requires one to know what one's interests are. For grand strategy, this means Member States' national interests and the interests of

the EU as an entity. Strategy must also address requirements and constraints and balance the two by prioritising. This requires judgement, which in its turn is based on a deep understanding of interests, short-, medium-, and long-term, and the values and principles by which these interests are determined.

The real utility of 'a Strategy', in the form of a published document, is in its ability to motivate a community to act coherently or in a self-disciplined way to achieve a shared objective. As such, it is a tool of leadership, part of the EU's crucial "Strategic Communication" process. It will normally need to be paralleled by a confidential strategic assessment which must be constantly amended and updated as a basis for the EU's strategic response. The openly published documents are part of the Strategic Communication action – they must inspire our populations and officials, but confuse our opponents!

The EU's Strategic Challenge

The strategic challenge facing the EU is: In a dynamically changing world of over 7 billion people, most of them young, how can the EU best use its assets to influence the course of events? How can it maintain its place, ensure its security, create and exploit opportunities in the peoples' interests? How can it transform its own institutions to cope with the drastic changes in the world and remain fit-for-purpose, whilst helping its Member States (particularly the smaller ones) to make the same transition?

The second (and commonly neglected) part of this strategic challenge is the challenge to think and act strategically. Unless the EU can achieve a better understanding of strategy and grand strategy, and enhance its capability to act strategically, the EU and many of its Member States will find it increasingly difficult to protect their security and advance their interests in the world in general, and in the rapidly developing relationship with China in particular, as the latter grows in importance as a player on the world stage.

The fact is that, for many years, the intellectual abilities of successive leaderships of the EU, and no small percentage of the leaderships of some of its key Member States, have been turned to thinking strategically only about the EU's *internal* structure and functioning. *External* strategy has been neglected. This is understandable, given the way the EU has evolved. But it is no longer acceptable. Furthermore, it is well understood that many in the EU and in some Member States are uncomfortable with the idea of the EU doing 'Strategy' and 'Strategic Thinking' because, within the overall framework of governance and statecraft, these are more tools of leadership than they are of management. After a long period of relative peace, stable development and economic prosperity, many Member States have stopped thinking strategically. Without strategy and strategic thinking, essential organisations stop evolving.

Governments in many EU Member States have seen the growth of 'management' as the key to solving all problems. Risk is seen as entirely bad and threatening to the existing order. Self-interest begins to predominate as the sense of a need for collective, concerted action fades, and the sense of community interest is lost. Social responsibility and cohesion become fragmented and the concept

of the “common good” gradually fades. Methodology takes hold, in which the process becomes the most important thing. Outputs replace outcomes as the key measure of performance and reward.

It is to counter this internal tendency that the EU needs to develop its capability to do external grand strategy, however institutionally difficult that might be. If the obstacles to developing a formal capability are forbidding, then an informal capability needs to be built first. The most important component of strategy – competent, educated people – is available within the EU. These intellectual resources need to be harnessed as a first step; other components may need to be acquired or created. The checklist below identifies the essential and desirable components:

Resources which the EU (or a Member State) needs if it is to do strategy and grand strategy

- an adequately competent governance structure , well-staffed, capable of discharging the strategic and grand-strategic responsibilities
- a body of people in all sectors of the EU (or national government) who are educated so that they think strategically (from which can be formed a corps of qualified professionals when political circumstances permit) and who have:
 - broad education and formal training
 - experience, enabling learning
 - constant refreshing, updating and sharing of ideas
- a system to enable these people to understand (and keep pace with) the changing world, including:
 - information gathering and analysis
 - research
 - experimentation
- a mechanism and process, formal and informal, to enable these people to do strategic planning, comprising:
 - no single plan, but constantly renewed planning
 - cross-disciplinary team
 - cross-departmental process
 - inter-governmental links with Member States
 - when it becomes politically possible, a formal headquarters organisation as a base for the above processes
- a leadership mechanism to engage Member States in the strategy process:
 - taking account of different views and incorporating them
 - providing a lead in a complex environment (especially for smaller states)
 - communicating what is necessary to communicate and keeping secret what should be kept secret
 - taking responsibility for error and redirecting as necessary

3. The Nature of Security and the Role of Hypercompetition

Security in the 21st Century

For most people in Europe and in those developed parts of the world which had grown up in the European, Westphalian tradition, states were defined by their geographical boundaries or by a single or dominant cultural identity. In these states for most of the 20th Century, *security* was understood as either “State Security” (counter-espionage or counter-subversion/terrorism- “internal security”) or as “Defence” (external security). The strength of a state’s armed forces determined its security in the international environment. States developed national institutions accordingly: armed forces; police; secret services; War/Defence Ministries, etc. all with separate, clearly defined functions. There was usually a clear distinction as to whether a country was at war or at peace.

However, this has changed as the 21st Century has advanced. Due to the rapid and profound changes in the global environment, the very nature of the instabilities and the resultant competition and conflict has changed. The potential for classic military confrontation and engagement is by no means over. But for a variety of reasons it is no longer the preferred means for many states (and, increasingly, non-nation-state actors as well) to compete and establish their place in the world. In some cases it is the cost of preparing for war, the uncertainty of its outcome and the subsequent economic and social impact which persuade states to pursue their interests by less “kinetic”, but no less fierce, means. In other cases it is the military preponderance of the competitor or, in the world as a whole, of the USA, which makes classic warfare less attractive as a means of advancing one’s interests, whether as a state or as a “non-state actor”.

The recent examples of Iraq and Afghanistan provide instructive examples of the limitations of classic military power. In the former, a conventional force-on-force engagement resulted in swift military victory for the superior military power, but saw the victors impoverished by the costs of stabilising a larger subsequent instability. In the latter, the world’s two most powerful military forces, the Soviet Union and NATO have each attempted to subdue the world’s fourth poorest nation - and lost. In doing so they incurred exorbitant costs, significant reductions in their global influence and serious damage to their interests (which in the Soviet case significantly contributed to the breakup of the country).

This issue has grown ever more rapidly as changes in societies around the globe have opened up vulnerabilities and have thereby created new opportunities for alternative forms of power to match classic military power in effectiveness. Military superiority is no longer necessarily best met by like alone – other forms of competition have displaced the simple arms race.

This requires that we define what we mean by *power* in each context; the power to do what? When we are confident that we know what forms of power we are likely to need in each case, then we can set about devising the kind of *tools* we will need to generate that power, and how these tools will interact when used in combination. Types of power might include diplomatic activity, economic action, development aid, political pressure, legal action, capacity building for good governance, security sector reform, and many others. This is not new. The British philosopher Bertrand Russell, writing in 1938 in his book “On Power”, showed that he really understood the different forms of power and their importance. But the ideas have been lost in the black-and-white world in which we

lived during WWII and the Cold War which followed. We now need to regain that lost understanding.

The 21st Century Paradigm for conflict, as it appears to be developing, is characterised by the following features:

- The terms *defence* and *security* are not synonymous. Military and even economic might no longer guarantee security, (e.g. Israel has a strong economy and stronger armed forces than ever before, but this no longer brings the Israeli people the sense of security which it did in the past).
- There is no longer any clear distinction between internal and external security; what happens in Afghanistan or in Gaza has an instant impact in European countries with their growing Asian and Muslim communities.
- ‘Weapons’ used are not only military, indeed are not primarily military, but include many other forms of exercising power, e.g. economic, political, informational, electronic activity
- Victory cannot be determined simply by success in fighting.
- The default setting in peoples’ minds is uncertainty. It is not at all clear whether we are at war or at peace, nor what kind of threat we might be facing.

It is dangerous to assume that the traditional governmental tools designed for an earlier, simpler age - with which most EU Member States are still equipped – continue to be appropriate and effective. With European countries rarely spending as much as 2% of their GDP on defence, classic kinetic military operations are likely to be less and less an effective means by which they can exert influence and power.

Furthermore, because of the migration and resettlement of peoples, the ease of global travel, the availability of electronic communications and of information, today’s state is no longer simply defined by its geographical boundaries or by a single cultural identity. Its *interests*, therefore, are no longer co-terminous with its physical boundaries. The geographical territory is a meeting-place of networks of identity, communities-of-interest and loyalties. Today’s state is a “Network-state”, linked to other network-states, competing and conflicting with other network-states. Both the EU and China are best understood as “network-states”.

Another major feature of this “globalised” world is the multi-national company. Not only does international business link countries together (not a new phenomenon) but the larger companies have their own identities, jurisprudence, interests, culture and loyalties. They not only contribute to the network-state, but now effectively constitute “network-states” in their own right - independent players competing on the world stage. Their existence also complicates the relationship between the EU and China.

One practical result of this change - revolution is not too strong a word – in the nature of security is that, whereas 25 years ago most Western nations shared a common understanding of what constitutes security and what was needed to achieve it, this is no longer the case. Every EU member has a different concept of security. Sometimes these are formalised in a document (A “National

Security Strategy”), sometimes not; sometimes there is a constitutional body charged with maintaining this concept or strategy.

This complete lack of common understanding gives rise to dramatically differing national policies. For example, some countries consider national control and ownership of key strategic assets (e.g. energy generation, water supplies, defence industries, hi-tech R&D) to be a key element of national security. Other countries, such as the UK, are happy to sell off these enterprises and elements of critical national infrastructure to foreign ownership, seeing the inward investment thereby generated as being more important than ownership or control. Indeed many question the notion of “ownership”.

A key task for the EU to initiate is a study of what constitutes national security, to point out where are the “red lines” which no Member State should allow to be passed. This would be a most useful starting point for developing a common understanding of national and collective interest and creating an EU capability for strategy-making and strategic thinking.

Hypercompetition

The predominance of military power as the defining power in the security relationship between states and other global actors has been replaced by a permanent, intense, all-embracing competition. This, we assess, is the defining characteristic of the modern global environment, the practical manifestation of “globalisation” in which the EU must regulate its relationship with China. The term we are using to describe this new global environment is: *hypercompetition*. Hypercompetition most effectively describes the nature of the relationship between the EU and China.

Hypercompetition is not just a sort of game. There are no agreed rules. It is bounded only by what you can get away with. This is the most prevalent and insidious form of instability in today’s world. Conflict and competition are being waged by ever more varied and ever less predictable means. What constitutes a weapon in this new “hot peace” no longer has to go bang. Energy, cash as bribes, corrupt business practices, cyber-attack, assassination, economic warfare, information and propaganda, terrorism, education, health, climate change or plain old-fashioned military intimidation are all being used as weapons of hypercompetition by many countries, China included.

Because we are in a networked world, achieving a success in hypercompetition is not an issue of *control*; it is an issue of *influence*. We need to make ourselves alert to how others are trying to influence us, and we need to be aware of how everything we do will have influence. We need to use that influence consciously to achieve our ends. This is not an argument for cynicism, nor is it to say that everything we do should be calculatedly self-serving. But it is to say that we should not shy away from the fact that, for example, our international trade serves our political interests; that the circumstances created by our international intervention, be it with military force or stabilisation and development aid, should properly be exploited in our commercial interest.

China has clearly understood the reality of hypercompetition and the need to develop, employ and master the various forms of power (not just military power) that have utility in today's world, China is consciously deploying these as tools in pursuit of her policy goals and to further her national interests. China is not the only country to do this, far from it. But not all countries have this understanding. Many governments, including in some Member States, have only the vaguest notion of the nature and intensity of hypercompetition.

In fact, Member States within the EU are in constant competition with all those around them, just as they, and the EU itself, are in constant competition with potentially (or actually) hostile states and organisations. Only the extent and nature of the competition will differ. The EU was founded specifically on the recognition that competition was fundamental to societies and with the aim of preventing that competition between European countries from escalating into armed conflict, as had so often happened in the past. But the EU has not done away with internal competition!

But, once hypercompetition is employed, and you are aware it is happening, you have no choice but to "join the game". It is naïve in the extreme for anyone in the EU, in Member States' governments, or even in major NGOs to think that they can stand aside from this process; that what they do can be somehow divorced from national or international interest or competition. An individual or a department within the EU can have the purest motives for their actions and can act out of pure altruism. But those actions will play into the hypercompetition nevertheless, and be judged by competitors accordingly. Those institutions, national and international, which do not develop this hypercompetition mind-set and do not realise the nature and extent of the process will find themselves ever more rapidly disadvantaged in their international relationships.

4. Chinese Policy towards the EU

Determining the *intent* of Chinese policy is much more difficult, and open to much greater differences of opinion and variations of judgement, than determining the facts of Chinese strategy and tactics as we observe them.

It is not within the remit of this Report to explore in depth the issues which have shaped modern China and which determine Chinese thinking, and therefore underpin Chinese policy towards the EU. However, as China sees the world through very different eyes and not from the Western perspective (which, in Europe and the US, is often mistakenly taken to be the *right*, or even the *only*, perspective), it is worth our summarising those factors which, in our opinion, have such a great impact on Chinese thinking that not to take these into consideration will result in our failure to understand and correctly interpret Chinese policy initiatives.

The first such factor we take to be the ancient traditions of Chinese culture and lessons of past history as the longest surviving polity on the planet. China has been a nation state since 206 BCE and by 41BCE was already half its current size. Although, as it expanded, the Han state absorbed other ethnicities, it absorbed these fully into its culture. China has never been multi-cultural. 90% of the Chinese population think of themselves as the same race. There is an unparalleled correlation between culture/civilisation and state. Confucius' philosophy of the primacy of the state, society and the family, in that order, has always been at the heart of this culture. The cult of the individual has never had hold in China. Preservation of the culture and security of the state, therefore, are at the root of China's policy today, as they were in ancient times. The state is the personification of the culture. The wisdom of China's strategic thinkers, most famously Sun Tzu, and their skill in understanding and applying the principles of politics and war in defence of the state, still guide policy. Chinese who leave China carry this culture with them and bring a piece of China to wherever they settle as a community, maintaining their link with the mother country. This contributes to modern China's ability to act as a network state par excellence.

The second factor we assess as China's experience in the 19th& 20th Centuries of being at the mercy of foreign powers, from the Opium Wars of the British and other Europeans, to the Japanese WWII invasion and the subsequent Soviet influence. Within living memory, China has had very painful experience of several catastrophic disasters which have wiped out large parts of the Chinese state and which have been beyond the power of any group or Party to fix. The basis of Chinese policy today is how to cope with this challenge and prevent it from happening again.

This experience of humiliation, fragmentation and disorder has provided Chinese policy with its obsessions with preserving unity, with ensuring China's ability to keep foreign influence and interference at bay, and with ensuring that China, as a nation state and as a culture state, can take its rightful place in the global order. This global order is one in which China will not accept the hegemony of any other nation or culture. *Anti-hegemonism*, i.e. countering the perceived US and Western dominance of the global system, is one of the fundamentals of China's policy. China is striving to create an alternative system, seeking as allies in this endeavour those countries that feel disadvantaged by the current (US-centric) system or which the US system considers pariahs.

Security and independence require that China be self-sufficient in materials. That access to essential communications, trade and supply routes, be guaranteed. Survival also requires China to ensure that it is fit to adapt and flourish in today's rapidly changing world. Learning and adaptation, however, must not threaten the integrity of Chinese culture nor imperil unity. Whereas Europe is moving towards smaller political entities within a federal framework, China's policy default setting is to move in the opposite direction.

This is not to say that China is monolithic - far from it, although China's information strategy seeks to present it as such to the EU, often successfully. Commercial corporations which are developing from state enterprises are coming to have their own agendas; different regions are almost city-states; wealth, class and family still influence politics; there are many tensions within modern China that could still tear the country apart. A study of where the power lies in China, and who makes policy, is a very worthwhile occupation. One reason for China's government to seek always to present a united front to the world is to dissuade competitors from exploiting these differences and vulnerabilities. That said, the Chinese approach does have a natural coherence and there is a much greater shared understanding and vision than one finds in many other large countries, not to say entities such as the EU.

The third factor reinforces this coherence. From their Soviet allies, the Chinese absorbed an admirably comprehensive, intellectually coherent, highly disciplined and precise structure of thinking. This provides them with a most valuable framework for the rigorous development of policy and strategy, and makes it easy for them to educate a large body of people in that way of thinking. The framework encompasses all supporting aspects, forcing students of the method to take into consideration such issues as equipment acquisition; education and training; gathering information, etc. in no way is this a restrictive process, nor is this something limited to military or security thinking.

Maintaining the Communist Party in power, and ensuring it has as much of a monopoly of power as possible, is the fourth main factor moulding policy. But the Party, for all its nepotism and accusations of personal corruption, has seen the need to adapt, indeed to devise a mechanism for constant adaptation. Once the Party becomes a drag on efficiency, it will have outlived its usefulness, just as happened in the USSR. So far, the Party has succeeded in "riding the tiger" that is today's fast-developing China. It is determined to continue to do so.

All these factors together not only give Chinese policy towards the EU a high degree of coherence, they also imbue it with an unmatched capacity for long-term thinking and acting. The short-term perspective of Western, democratic politics and of Western business means that the EU institutions invariably tend to interpret Chinese actions from a misleading, short-term perspective. The underlying long-term intent is obscured. This is perhaps the most important practical point to understand about Chinese policy. Coupled with the strategic aim of achieving the fitness to operate effectively in the rapidly changing global environment of today (rather than simply seeking world dominance, which is how China is often perceived), and the understanding that the ability to adapt is *the* crucial quality to enable survival in this, as in any, eco-system, an appreciation of China's long-term vision is the lens through which we must evaluate all China's actions towards the EU.

5. Chinese Grand Strategy as it Affects Europe

Chinese policy towards the EU is implemented through its Grand Strategy. In addition to the above discussion of strategy, security and hypercompetition, there is one more important aspect of today's world that has a bearing on how states and international institutions develop their Grand Strategy. That is, that the environment itself is a major factor. To understand the significance of this as it affects the China-EU relationship, it is best to consider that relationship as developing within an *ecology*, in a Darwinian sense.

Just as living things compete with each other and at the same time struggle against the natural environment, so to do societies, states and other actors in the world's political and economic environment – i.e. *hypercompetition*. The environment, natural or political, is constantly changing. Just as Darwin noted that the animals most likely to survive and flourish were not the largest or the strongest, but those best able to adapt, so the same can be said about societies and their institutions. Indeed, Marx made exactly that point in 1855, commenting on the revolutionising impact of war on societies incapable of adapting.

The Chinese have understood Darwin and Marx, and they understand that not only do environments change, but that they can *be* changed. Mankind is changing the earth's natural environment through carbon emissions. China understands that, because of its scale, its actions will change the world's political and economic environment significantly. China is therefore seeking to ensure that its impact will change the global environment *in its favour*. This is a most important point. It means that the EU, as itself a global actor, needs to understand that China's impact on EU security is not only through its dealings with the EU and its member states, but through its actions worldwide. These are not secondary or incidental, but primary effects. The evolution of the EU-China relationship is taking place against the background of a changing environment. That environment - political, economic and cultural - is being deliberately and systematically changed by China, as best it can, to favour itself and disadvantage its competitors, including the EU.

Strategy in Practice: The Key Role of Knowledge

To change the world in your favour, of course, firstly you need to understand it; secondly, you need to make yourself fit to operate within it. Knowledge is the key. For most of the 1980s, China was reaching out tentatively to the world from which it had been isolated by Mao and the Cultural Revolution. China understood well the need to catch up, the need to understand what it had lost and what it needed to relearn if it was to regain what it saw as its rightful place in the global order and to avoid being a plaything of other countries. By the early 1990s, China had settled on three essentials to be at the core of this catch-up programme; the English language, computing, and what we would call "competitive intelligence".

"Competitive intelligence" or "business intelligence" is a Western term used to describe ethical spying on one's competitors. It is perhaps the most appropriate term to describe the process set in train by China. The Chinese had observed (and indeed had experienced at first hand) the long-running US cross-departmental initiative to study systematically other countries' government and commercial scientific programmes. Maintaining a strong technological lead over *all* other countries,

close allies included, is still today at the core of US strategy. By the mid-1990s, China had begun its own comprehensive intelligence-gathering programme on similar lines, but on a vastly greater scale.

Furthermore, the Chinese brought to this programme their own understanding of the world as an interaction of networks. China understands that, in a networked world, neither it nor any other polity can control everything, only influence things; and that the actors are not limited to nation-state structures. They understood that large multi-national companies and international organisations operated as quasi-states and were also worthy targets. The intelligence process they have in place today is unparalleled in its extent and comprehensiveness. Nor is it just information-gathering. China has set up a system to evaluate and learn from the knowledge it gathers, to apply it in a way that helps develop Chinese society and advances Chinese interests.

This system is now fundamental to all Chinese interaction with the EU, as it is with the rest of the world. It employs the traditional collection methods of diplomacy, “friendship societies” and spying, of course. But it is in its other collection tools that the system is so remarkable in its extent and depth. These include “cyber warfare” and “hacking”, discussed in detail below. They include exploitation of the Chinese Diasporas wherever these are amenable to collaborating. They include paying foreign commercial companies to obtain information. They include China’s huge academic outreach programme, also discussed in detail below; and they include China’s business and financial initiatives worldwide, a case study of which is given below. This, it must be reiterated, is not something which is a *threat* to the EU by China; it is the reality of everything China is doing with and to the EU.

China’s Strategic Understanding of the EU

China, then, has studied the EU very closely and understands it very much better than the EU as a whole understands China. Because China can both think strategically and can implement a highly coherent, flexible strategy (which the EU as yet cannot), it understands that the EU is simultaneously a competitor, an opponent, a market, a source of knowledge and an ally and, depending on the circumstances, treats it as such. It understands the economic weight of the EU and is determined to benefit to the maximum by exploiting that in China’s interests. Through its competitive intelligence process China knows exactly how to do that, and exactly what the EU and each Member State possess which would be to China’s benefit. It also understands the weaknesses of both the EU and each of its Member States, the EU’s lack of political unity, and how to exploit those weaknesses to its advantage. As China modernises and grows, there will be less need for the EU as a market, or it will become a competitor and a supplier of high tech goods designed in China.

China has come to have a particular disdain for the EU’s central institutions on account of their weakness and because of the EU leadership’s inability or unwillingness to use the organisation’s strength as power. China respects power, recognising that it comes in a wide variety of forms, not just, for example, military. An example of the EU’s failure to turn its strength into power can be seen in the EU’s willingness to deal with China without demanding reciprocity, to allow China freely to take advantage of the EU.

For the EU to engage unconditionally with China in the hope or belief that this will evoke an analogous response from China, or will somehow influence China to liberalise, to become like Europe or to adopt European values, is a serious psychological mistake on the part of the EU. This is seen as weakness and evokes only contempt, actually increasing the Chinese temptation to profit from the EU's perceived powerlessness. China has a very clear understanding of what it thinks its interests are and it will pursue those interests mercilessly. If the EU wants to influence China's behaviour, it will only be able to do so from a position of strength and with a demonstration of the appropriate form of power. Empty political gestures or declaratory statements by the EU or the European Parliament, if not backed up by the application of power, will be dismissed out of hand.

Divide and Rule

An analysis of China's dealings with the Member States indicates that China today identifies a five-tier Europe¹.

Tier one consists of Germany alone. Germany is the country which China thinks has most to offer it. The two economies are compatible, macro-economically. Germany is responsible for 44% of total EU trade with China and is the chief funder of the EU and Eurozone and is therefore more important a power centre than Brussels. China is keen to get German technology and managerial expertise. German companies want Chinese money. Germany is also seen as a tough, competent partner and, as a consequence, gets China's respect as well as, unfortunately, a great deal of attention from Chinese state-sponsored cybercrime. Having identified Germany as the main power-broker in the EU, China has now started trying to use Germany as a weapon to weaken Brussels' competence to set trade policy, which is the sole remaining power Brussels has that China knows can actually do damage to its interests. Whatever the rights or wrongs of decisions taken by Brussels in the trade field, trying to overturn Brussels' decisions at the behest of China weakens the one area where Brussels can still make a difference. Premier Li Keqiang chose Germany as the first country in the EU to visit in May 2013 – and did not come to Brussels.

Tier two is formed by the Nordic countries and the Netherlands. They are seen as being like Germany, but on a much smaller-scale, and consequently given less attention.

Tier three includes France and the UK. The Chinese perspective appears to be that these two countries have an inflated sense of their own importance, largely due to their historical baggage as former major colonial powers. China considers that the two former powers act as if they still carry substantial weight in the world, but also assesses that they can no longer turn their ambitions into reality so easily because their national institutions have not evolved to keep pace with the times and are largely obsolete. As a consequence, China perceives that these countries sometimes take actions beyond their real capabilities that fail to impact or that backfire. They expect that trade will follow a

¹It is appreciated that this is a very rough-and-ready analysis, that we could debate exactly where some countries lie, and that it leaves out some countries that do not fit easily in one tier or straddle tiers (Belgium, for example). But it is borne out quite consistently by China's dealings with the Member States and it is a useful tool when we are assessing China's strategy.

good political relationship, rather than vice-versa. They do not fully understand Chinese thinking and often miscalculate in their dealings with China.

Tier four is comprised of countries that joined the EU from in 2004 onwards, plus candidate states from the Western Balkans. There is quite a lot of diversity within this complex group, and it may subdivide. But for the moment there is enough commonality for China to try to treat them as one sub-regional group, as discussed below. China's relationship with these countries also reflects the tensions between China and Russia and between Russia and Germany, particularly on energy issues as regards the latter, where they look to Brussels for support. Many of these countries offer a suitable base for Chinese operations in Europe and as a channel for trade. For historical reasons, Romania has the strongest relationship with China. Poland and the Czech Republic are seen as the most robust and competent, and Poland is viewed as the country with the best strategic thinking in the group.

Tier five is Southern Europe. These China sees as countries which have been the most economically and institutionally weakened by the global financial crisis and therefore present a soft underbelly through which China might be best able to penetrate certain European markets. Some of them have enough weight of technological and managerial excellence to warrant serious attention from the "competitive intelligence" operation. Some have political systems in which politicians and industrialists are seen as being more open to personal, informal financial blandishments than in some more northerly Member States.

Based on this pragmatic strategic analysis of Member States, China is today pursuing a fairly blatant policy of "divide and rule", paying as little respect as possible to the EU's central authority, and indeed, seeking to lessen that authority. Making good use of the access it has enjoyed through the EU-China Strategic Partnership, China has spent the last decade or so gaining a really good understanding of the EU and how it functions. It has noted the weaknesses of central institutions; it has seen that Member States are acting increasingly in their self-interest and independently of Brussels, rather than for the benefit of the whole. As a consequence, China now gives higher priority to its direct relationships with Member States than it does to its relations with Brussels.

China prioritises its relations with the Member States based on a balance between China's perceived interests and the opportunities offered by the mind-set or by the problems and vulnerabilities of each state. Again, it would appear that China has overall a better understanding of Member States, their strengths and weaknesses, than many of the Member States have of China. Certainly China has been observing Member States vying for preferential access to China, and naturally uses this to manipulate them, playing them off against each other and lobbying individual Member States to try and influence central EU decision-making when this suits.

Nowhere is this Chinese attitude better illustrated than in its current policy of "splittism", i.e. dealing with ad hoc regional groups of Member States, as noted above. EU Member States have a perfect right to deal bilaterally with China. But China is making a concerted effort to encourage countries at sub-regional level to form blocs to work with China. This is in flagrant disregard of the EU's stated wish to China that other countries deal either bilaterally with Member States or through Brussels. China is increasingly creating these sub-regional blocs to work with in its own interest, especially

amongst the newer, smaller and/or economically-stressed EU Members, thereby simultaneously weakening Brussels and strengthening its own influence with those Member States.

These smaller Member States are often in the situation of trying to raise their profile in China and are frustrated that they cannot get the same level of access and attention as larger States. Acting within regional subgroups get them meetings with the Chinese leadership which they could not otherwise get. As a result of its careful “grooming” of selected Member States, China can now rely on some countries to be more favourable to its policies and to support its cause in Brussels. By contrast, Member States – particularly the larger ones - which take positions on issues which oppose Chinese policy are “put in their place” with diplomatic snubs, such as that meted out to the UK for its very public political welcome of the Dalai Lama in 2012.

The increasing contempt which China is showing towards the EU’s institutions is matched by its treatment of the European Parliament. Having developed close relationships with various political groups at the European Parliament and, through them, having come to understand the weakness of the European Parliament and how easily it could be manipulated, China realised that it could ignore its former parliamentary partners’ wishes with impunity. It chose, therefore, to host this year’s EU-China party political forum on its own terms in China, favouring invitations to national parliamentarians rather than to MEPs, without consulting their original hosts. This was probably also because of the European Parliament’s regular high profile taunting of China on its human rights record. As it is the turn of Europe to host the event in 2014, we wait to see how the Chinese will play it next year.

If all these instances are considered separately, they could be dismissed simply as “normal” diplomatic manoeuvring. But, considered as part of a coherent strategy, they can be recognised as an increasing trend on the part of China to diminish the EU and undermine its solidarity. This trend provides evidence that China’s attitude to the EU has changed over the past decade, moving further away from “partner” towards “competitor”, Chinese protestations to the contrary notwithstanding. The hypercompetition is hardening and the sooner this is understood in Brussels, the better. The next step to look out for is a regional subgrouping of EU Member States to accede to a Chinese request to create its own secretariat or a permanent HQ of any kind to work directly with China. If there is ever a temptation for any such structure to be created by a group of Member States, a dangerous precedent will have been established. This must be a “Red Line” for the EU and its Member States.

6. The Competition for Resources

We have noted above the Chinese capability, through its scale and through its focused grand strategic approach, not only to engage effectively in competition with the EU, but also to change the very environment in which that competition takes place. In this respect, the carefully planned Chinese acquisition of assets and resources worldwide has a huge impact on the internal security and wellbeing of the EU.

The EU so far has failed to appreciate three parallel factors which strengthen Chinese relative power and weaken that of the EU. The first is the dramatic increase in the scale of Chinese acquisitions worldwide, both in developed and developing countries. Some of these acquisitions are innocuous and understandable from a purely commercial perspective. But other acquisitions, initially primarily in developing countries, but nowadays increasingly within the EU's territory, must be seen as having a strategic aim. These acquisitions give China significant control of key infrastructure, or exclusive access to key resources. For example, they lock in control of fossil fuel and mineral resources for China over the longer term.

In terms of resources, this first factor is reinforced by a second factor - the increasing strategic vulnerability of EU, particularly in respect of fossil fuel resources. The EU faces a decline in conventional resources, whilst the United States, China and others are beginning to exploit unconventional fossil fuel resources on a large scale.

The third factor is the increasing 'resources isolationism' of the United States. The US increasingly has less need of Middle Eastern energy resources and may well take the view that the Chinese search for resources is not of a strategic interest to the United States.

These factors together expose significant strategic threats to the European Union: increasing energy vulnerability in a world where everyone else will become less vulnerable; a growing likelihood that the United States cannot be relied upon to protect the external economic interests of the European Union, and; increasing Chinese lockdown of fossil fuel and natural resources. The US economy needs to expand in the developing world more than in a Europe, where it is already in a strong position.

The Scale of Chinese Acquisitions and Operations

It is the scale and clear strategic focus of Chinese activities which creates the impact on the global environment. The International Energy Agency (IEA) assesses that by 2015 China will be producing 3 million barrels a day (mbd) of oil *outside* China. In 2012 alone China made \$35 billion of acquisitions in energy infrastructure. Sinopec alone has made acquisitions totalling \$92 billion since 2009. In addition to energy, there are specific concerns in respect of specialist mineral and rare earths, which surfaced in 2010 when China stopped shipments of rare earths to Japan.

In Africa, Chinese trade in 2011 was \$106 billion. This is ten times the trade level of 2000. Over 800 Chinese state owned companies are now operating in Africa. China is now the third largest investor in Latin America with acquisitions of \$23 billion (total scale of investments between 1990 and 2009 amounted to \$7.3 billion). Whilst Chinese experts argue that this investment is purely commercial

and is deployed to feed the needs of the world's no.1 manufacturing power, it would be naïve to ignore the foreclosure effect of limited resources being placed in Chinese hands.

China, the EU, and Energy Security

China's impact on world markets as an energy importer is well known. But China's efforts to reduce its energy dependency, and the vulnerability this brings with it, are less well known. Chinese Plans for the development of shale resources are well advanced. China has larger shale resources than the US, estimated at 36 trillion cubic meters (tcm). Initial Chinese plans estimate 60 to 80bcm production by 2020 and there is significant potential for shale oil.

It is true that China faces several obstacles, from water shortages to pricing structures, in the gas sector. However, potential energy security advantages are immense. There is a very high likelihood that China will develop these resources over the next decade. New technology, for instance liquid natural gas fracturing, may mean that the Chinese do not have to use water in the extraction process.

However, in the medium term, China will need to increase its energy imports and this will bring it into increasing competition with the EU, often in "difficult" parts of the world. China's investment in infrastructure in the Middle East; Chinese engagement with Iran, Venezuela and Argentina; and China's buying up of EU technology companies and sending of students to technology centres in EU universities are all relevant to this competition.

Because we so often operate in stovepipes, European energy specialists concentrate on deals which affect them directly, and overlook Chinese energy acquisitions worldwide, including acquisitions into unconventional resources and particularly into technology. China is developing a knowhow and technology base to exploit its own domestic unconventional fossil fuel resources. We should expect China to become a much more powerful player in the energy field in the coming decade. This will inevitably have an impact on the EU's energy security.

The China-EU-US Triangle

The EU's energy security and the EU's relationship with China will both be impacted by developments in the United States. Thanks to shale gas, the US is already 'independent' in gas for the foreseeable future. The 'on-shoring effect' of manufacturing moving back to the United States (to take advantage of cheap gas) is also making Europe more vulnerable. As this trend develops, it will make the US less dependent on Chinese manufacturing supply chains and therefore able to contemplate a much more isolationist economic and security policy. Furthermore, the US is likely to be 'independent' in the production of oil by 2020. This may well be an under-estimate due to the fact that the cheap price of gas has seen a major switch in drilling to shale oil plays across the continental United States, and the imminent use of gas as a motor fuel on a large scale will further reduce oil demand.

The strategic impact on Europe of US energy independence could be considerable. The US will no longer need the Middle East for its own energy supply security, just at the time when China will be seeking to buy significantly more energy. Not only does this explain the Chinese interest in investing in acquisitions in the Gulf and its engagement with Iran, it also provides a significant motive for China's increased defence spending. For six decades, the EU and many of its Member States have been able to reduce defence spending to a very low level, safe in the belief that the US would continue to invest in military strength in Europe and the Middle East. This investment can no longer be assumed. At the very least the EU will be faced with demands for greater security investment in the region. Indeed, one day the EU may be forced to replace the USA *militarily* in the Mediterranean and Middle East region.

Declining Energy Resources in Europe

To compound this complex strategic picture, the EU's own energy security situation is deteriorating. The North Sea resources (Europe's principal fossil fuel resource base) are declining rapidly. Eastern Mediterranean gas may provide some support, but it is open to question how easily that resource base will be developed given the 'above ground risk'; i.e. the Law of the Sea disputes in the region; the Cyprus question; Israeli-Palestinian conflict. North African resources are becoming increasingly problematic because of the security situation in the Maghreb.

In fact, as Latin America, China and the United States (and probably India and SE Asia too) develop their energy resources, Europe will become the most strategically vulnerable in energy terms of any major bloc on the planet. Paradoxically, this European vulnerability may well be reinforced by a collapsing oil price. This process would come into place as much larger quantities of fossil fuels come on stream. A strategic downward shift in the oil price could generate significant instability in both the Russia Federation and Saudi Arabia, negating the potentially positive economic effect of cheaper oil.

The danger for Europe is that China will have locked down sufficient external oil resources and have domestic gas supplies, whereas Europe will remain much more vulnerable to any instability. The EU's security would decline relative to that of China, and it might bring the EU into much sharper competition, even conflict, with China.

7. Investment as a Tool of Strategy

Investment is currently China's single most important tool of strategy, both internally and externally. A study of *where* and *how* China makes its investments is as good an indicator as we will get of China's policy objectives and strategic thinking. A key theme running through this report has been the importance of seeing "the big picture" if one is to understand Chinese strategy. Nowhere is this more telling than in a study of China's investments.

We have touched upon this several times in other sections of this report, for example in the competition for energy and scarce mineral resources addressed above, and in the global reach of China's strategy, as exemplified in Chinese interest in Latin America or the Polar regions, details of which are given in the Annexes to this paper. An investment, or even a trend in investments, can appear totally innocuous if assessed in isolation. That same investment can take on another significance altogether if assessed in conjunction with other activities, or if seen as part of a global pattern.

There is now a considerable degree of awareness in Europe of the fact that many Chinese corporations have such a close link with government bodies that they are effectively instruments of state power. The investments and acquisitions these "private businesses" make need to be viewed in this light, even though many of the European commercial or financial institutions (and frequently the Member State governments) involved in these deals -with an eye to the short-term political or financial gain they bring - would prefer this question not to be asked. The EU has a most important role to play here. Because of its position and the resources it has available, the EU can and should be the organisation which sees the big picture and brings this to the attention of its Member States, informing the governments of those countries which are not big enough to have this ability, and being the conscience of those which might be tempted to ignore long term or collective interests for short term individual gain.

The pattern of Chinese investment in Europe also helps us to understand something else about the nature of China's dealing with Europe. That is, the extent to which Chinese State activities reflect cultural attributes which European traders who have done business with China over the centuries have always understood, but which European diplomats sometimes seem to have difficulty seeing. That is, the Chinese are great businessmen. They are natural risk-takers; they have a great eye for a bargain; they will exploit a weakness ruthlessly; they will work according to their own rules, not yours; they can be relied upon to exploit every loophole in the law, contract or agreement to achieve an advantage.

These above points, taken together, suggest that, for the moment at least, it is futile to spend too much time arguing about whether a given Chinese corporation is, or is not, so close to the state as to be an agent of state power. The commonality of culture and the shared awareness of strategy and national purpose will shape the behaviour of Chinese entrepreneurs just as they will of political leaders. The same can even be said to a large extent of Chinese organised crime, leading some to see illegal activities as merely another tool of government policy. Whilst this may be a step too far, there are certainly some interesting similarities which are investigated elsewhere in this report.

The lesson for the EU is that, not only is it important for the EU and member States to understand the threat China's strategy might pose to Europe's security, it is also important to understand how important it is to guaranteeing Europe's security for the EU to be able to exploit opportunities to gain advantage. Security is all too often seen only as something defensive or protective. But having the ability to see an opportunity and the ability to exploit it are just as important. Entrepreneurs everywhere understand this. China has understood that this principle applies to state activities as well as to commercial ones.

With this firmly in mind, China has made good use of the economic crisis affecting Europe, snapping up interesting pickings at low prices in weakened economies and in stronger Member States getting access to desirable opportunities (for example, the chance to buy into high-tech industries) which otherwise might have remained closed. Overall Chinese investment in Europe may not yet have risen as high as it might, and as some European institutions and governments might have hoped, compared to its potential. However, the strategic significance of much of the investment is easily underestimated, especially if it is considered only as individual, private deals.

The Trade Trap

Although, in terms of security, attention has focused on trade in IT equipment because the "hard" security aspect of IT is more evident, other industries face a "trade trap" with China that has serious implications for European and Western long-term economic security. As our larger manufacturing companies have become more "efficient", they have also become more vulnerable to the disruption of their economic model. The following example is from the automotive industry, but it could as well be from any manufacturing sector.

A large North American-based car and truck manufacturer with a strong European operation, an "Original Equipment Manufacturer" (in our example, OEM-1), relies on multiple component suppliers which it shares with OEM-2, OEM-3 and OEM-4 etc. Cheaper, and adequately good quality, foreign vehicles imported from, for example, a Far-Eastern country, undercut the car maker. This drives OEM-1's profit margins down as it has to reduce prices to sell vehicles. If left unchecked, OEM-1 will lose sales to cheaper foreign vehicles and be unable to sustain its business; it will stop paying its component suppliers and will eventually go bankrupt. A severe decline in vehicle sales was the problem faced by GM and Chrysler in the USA, leading to the recent automotive crisis and the Governmental bailout for these two companies.

But, if OEM-1 does close down, this will affect the whole supply base for OEMs 2, 3 and 4. As the volume of supplied components falls, economy of scale across all OEMs is reduced and the price per unit rises. This in turn will affect the other OEMs who will now have to find new, alternative, cheaper sources of many components to maintain their desired operating margins. As a result, domestic Tier 1 component suppliers also suffer falling profits and begin to fail, and so on. In the USA, the car industry had become so "efficient", with such tight profit margins, that if GM and Chrysler had been allowed to fail, the whole US car industry would have been at risk of collapse.

Consequently, Western OEMs are looking to emerging markets, both to build and sell vehicles in those countries, and to build vehicles and components for export back to Europe or the USA. China is not the only such “emerging Market”. Russia and India are two other examples. But China offers the biggest immediate potential. However, China also has two other features which make it a dangerous partner: it has a very close relationship between its big companies and its Government, and; it has a coherent national strategy and a very long-term perspective, of which its handling of OEM-1 is a constituent part. OEM-1, by contrast, is limited by commercial considerations to short-term (±approx. 5 years) planning and is operating largely independent of governmental strategic thinking, such as does exist.

In our current example, China offered OEM-1 incentives to set up manufacturing there on condition that they agreed to source a high percentage of component parts – up to 60% of some models - in China. OEM-1 accepted this condition. By sourcing components locally, OEM-1 has been investing in China. It has also been supporting the local Chinese Car market, as locally manufactured component prices have fallen with volume; local technology and quality have risen; and Western IPR has been lost through large-scale pirate copying with no hope of redress.

By reverse-engineering the foreign equipment, China has been seeking especially to improve its design capability, and to identify which technologies they should best be able to master and improve. Now OEM-1’s component suppliers are themselves having to move production to China to stay competitive, as China is also now in a position to specify which components (e.g. gear-boxes) must be locally sourced, ensuring that the gaps in Chinese design and production capability and capacity are filled.

As a result of this policy, China’s car market has been actively boosted by its Western competitors, enticed into moving out of Europe by incentives, squeezed by competition, thinking they can make big sales and profits in China. As sales increase in China, the Western OEMs are re-investing all of their profits to meet the increased demand, rather than exporting their profits. As the Chinese car industry improves and grows, benefitting from this “virtuous circle” of investment, it will soon be able to export low-cost, high quality cars in volume to Europe, to the further detriment of the European car industry.

China’s economy has been strengthened but European, and indeed Western, manufacturing capacity undermined by this “partnership”. The Western car industry has made a short-term gain, but is on a long-term downward spiral. China’s joint state-industry strategy has outplayed the big European and US-based companies at their own game, exploiting the very “rules” of the capitalist economic system to do so. Nor is China slavishly copying what it sees as the Western capitalist mistakes of short-term targets, over-centralisation and consolidation into a very few, ever larger companies. They are maximising growth, quality equipment and quality labour, rather than profitability. They are maintaining internal plurality and competition to avoid the complacency that comes with monopoly.

On the European side, lack of awareness, lack of co-ordination between companies and governments, and lack of strategic thinking are making China’s job a lot easier. EU Member States are thinking too locally. Companies need EU help and education to do longer-term strategic thinking to cope with this threat. Socially progressive EU policies regarding working-time or health and safety raise costs for indigenous manufacturers but do not penalise Chinese and other imports, creating an uneven playing field for this example of Hypercompetition. In the case of the automotive industry,

fuel prices also play a large role in influencing the consumers' choice of vehicle brand. An EU-wide, joint government-industry strategy is urgently needed to tackle the problem, which is not confined to the automotive industry. The ideology of "leaving it to market forces to solve the problem" will result in disaster for Europe.

Chinese Investment in Europe's Infrastructure

It is the strategic nature of Chinese investment in Europe which has recently raised concerns in some quarters, particularly concerning infrastructure. It is most appropriate that the EU should concern itself with this potential problem for its security. However, the first point for attention here is not the Chinese policy, but the very different attitudes and policies adopted towards control of infrastructure by the Member States.

The Member States have different definitions as to what constitutes security, and also as to what it is critical for the state to control in the interests of national security. The lack of a common understanding between Member States is an issue that the EU could justifiably address through its research and educational programmes. The conclusion is certain to include a degree of judgement and may indeed differ in detail from state to state. However, in the immediate term this different interpretation presents a problem, not least because the difference is in some case very stark.

For the past two decades or so, the UK has led amongst the major EU countries with a policy of encouraging inward investment at virtually any cost. Companies considered by the population at large as being iconic national brand names have been sold to foreign purchasers without restraint. Likewise, elements of critical national infrastructure, such as water supply companies, energy generation companies, ports and airports have been sold in whole or in part into foreign hands. These are the kind of investment which would allow a potentially hostile country to get access to key nodes in state structures at a time of crisis or conflict. Even the UK nuclear power industry and the management of nuclear weapons development are now in the hands of foreign countries.

Naturally, the assessment of strategic risk involved depends on the importance of the facility to national functioning or survival in time of trouble, on the level of trust between the host country and the investor, on the ability of the host country to monitor the investor's use of the asset in normal circumstances (i.e. when all is going well), and on the ability of the host to seize back the asset intact in good time in event of any serious trouble. In the case of the UK, the overriding government consideration has been to get money into the country, latterly to reduce the financial deficit. China has been relatively late coming to this sell-off of national assets, but is now making up for lost time by becoming a major investor in the UK.

Other major EU countries, such as Germany, take a different line, as in particular does the USA. The USA has a clearly articulated policy of maintaining a technological advantage over all other countries as one of the pillars of its national security and to ensure its national competitive advantage, backing this up with legislation, Congressional responsibilities and a strict regime of enforcement. Germany has a strong sense of economic security and of the importance of the advanced sectors of its industry to maintaining competitive national advantage.

As the economic crisis in Europe has progressed, most Member States and a great many corporations have begun to look to Chinese investment to bail them out in difficult times. The trend has been particularly marked in the southern tier of Member States which are experiencing the greatest financial difficulties, but even healthy companies in Germany are now keen to attract Chinese investment (China is now the largest external investor in Germany). China has been able to factor this into its policy of “splittism”, i.e. divide and rule, playing Member States off against each other or helping to form the unofficial regional groupings which are so disliked by Brussels, as noted above. The Chinese offer to Central European and Western Balkan countries in April 2012 of a \$10bn credit line for infrastructure and technology projects is a good example. Instead of joining forces to strike a good deal with China, or China working through EU institutions such as the European Investment Bank (as Taiwan does), these Chinese initiatives tempt Member States to compete with one another to attract Chinese investment.

This is yet another area where, to get a clear understanding of China’s strategy towards Europe and the significance of the scale of Chinese operations, it is important, firstly, to understand China’s extremely long-term perspective in its strategy. Secondly, it is important to study what China has been doing in other parts of the world, as it is now bringing to Europe strategic practices developed elsewhere. We have given at Annexe B the example of Latin America to illustrate this. But a study of Africa or the Middle East would be equally instructive.²

The Chinese model is to build up a chain of influence amongst local and national politicians to accompany its acquisition of influence over or control of transport links, local assembly, logistics and distribution. This is accompanied by the importation of considerable numbers of Chinese workers and by establishing local media influence and the influence in the education system described elsewhere in this report. At the same time, European countries get very little opportunity to compete for access to the same sectors in China, which in the main are closed to foreign ownership on strategic grounds.

As we noted above, all the key elements of Chinese policy and strategy are reflected in the investment activity. This includes the acquisition of or investment in companies such as Volvo and Saab for their high-tech R&D or advanced management procedures. The Chinese predilection for the acquisition of infrastructure in this regard reflects their own obsession with security.

We have already referred to the Chinese concern with self-sufficiency. This translates into the security of both delivery and of supply; that is, the Chinese only feel secure if they control the whole essential value chain. This includes: the supply to China or elsewhere of the raw materials essential to the manufacturing process; the manufacturing process itself and the means for developing and improving the product during manufacture; and, the delivery to the customer or the consumer. This draws China into investment in transport routes, ports, airports and roads; into shipping companies; and into the labour force. It provides a strong rationale for the current development of the Chinese Armed Forces to protect that chain. It explains Chinese interest in new transport routes, such as the Arctic ice-free route addressed in Annexe A.

² See also the excellent European Council on Foreign Relations’ report: “The Scramble for Europe”, July 2011.

In all human affairs, of course, things usually happen for more than one reason. The Chinese preoccupation with their own security and their determination to control supply chains are paralleled by a keen sense of what is strategically important in the classic military sense. This reinforces their interest in global choke points, in infrastructure important for force projection, for example airports and ports, such as Naples- also a base for the US Sixth Fleet in the Mediterranean. The cooperation between Chinese organised crime and the Camorra, also focused on Naples, may well be coincidental. But, if so, it is a fortunate coincidence in the way that it could increase the effect of Chinese levers of control in event of a crisis.

The whole issue of Chinese investment in Europe is clouded by a lack of transparency as well as by a general sense of unease generated by the speed of China's emergence onto the scene as a global power, by a lack of trust on the part of some countries and institutions emanating from cultural differences, but also by an ignorance or a drastic difference of opinion about what it is important to protect and what is not. China is with us as a global player, like it or not. In our venal, capitalist societies, Chinese money talks, and talks loudly. Member States want Chinese investment and benefit enormously from it. The important thing is to get this investment into perspective and to create mechanisms so that the investment can be welcomed without reticence because the mechanisms ensure that they can be seen not to jeopardise EU security.

An assessment of infrastructure investment will naturally concentrate on whether the said infrastructure will be available to meet national needs in event of crisis or conflict, be it with the owner or with a third party whom the owner might not wish to displease. But with some industries, especially in the high-tech field, encouraging Chinese investment in some Member States might well result in their dominating the market and driving the domestic industry out of business. This could leave that State, or the EU generally, without an indigenous capability to develop equipment or processes which might be crucial to future security. IT and cyber are obvious possible examples here, but others will undoubtedly emerge.

The rundown of defence industries across the EU since the end of the Cold War has affected many Member States and made them more vulnerable to the loss of what might in the future become critical R&D capabilities. This whole situation would be improved greatly if a serious study were undertaken to identify these critical industrial assets in each Member State so that measures could be put in place to protect them.

So far, the scale of Chinese investment in the EU has not been sufficient to change the environment across the Union. But the recent concentration of effort in the southern tier States may be moving them in that direction. One of the most effective ways of changing the environment in Europe, as in other countries across the globe, is the exportation of Chinese labour to service projects. European nations, by the way, did exactly that when they exported their populations to run colonies in the days of empires. The large numbers of Chinese citizens now resident in Italy, who have been taught how to run businesses in Italy by Italian business consultants working in China, are an example worth studying.

The Huawei Issue

One of the most controversial cases of Chinese investment in Member States' critical national infrastructure has been the UK Government's decision to allow Huawei, a Chinese company strongly suspected of having close links to the Communist Party and military leaderships, to provide crucial equipment for the UK's national telecommunications system. The same company has been debarred from providing equipment and services in the USA because it has not been able or prepared to demonstrate that its state links could not be used to pressurize the company to act against US security interests in event of a conflict developing between the two countries. The UK decision has been highlighted due to the increasing frequency of Chinese cyber-attacks addressed below in this report.

There are three areas where the UK policy could create a security risk. Firstly, Huawei could, now or in the future, insert undetected malware into the UK telecom system via its equipment, either to disable that system or to enable traffic to be monitored. Secondly, the presence of Chinese managers and technicians in the services associated with network deployment, maintenance and operations could present a human intelligence risk. Thirdly, allowing Huawei (or any other company) to become dominant in such an important field could destroy national (and ultimately EU) competence in this field, leading to Huawei having a monopoly position and China establishing technological preponderance which the EU could never catch up.

The UK decision to allow Huawei in was taken under very great political pressure, based on the economic circumstances of the case (without Huawei supplying the equipment at their knock-down price, the modernisation of the UK telecom system was just not affordable) and on the UK Government's determination to encourage Chinese investment in the UK, already addressed above. The decision was taken at a time when the UK technical community was reasonably confident that it could detect malware inserted in the equipment, and that the balance of risk was in its favour. The UK Government still strongly supports this decision and asserts that the Cyber Security Evaluation Centre which Huawei has set up in the UK fully satisfies all security requirements.

However, UK technical experts interviewed during the preparation of this report now express grave concerns on several points. Their unanimous view was that, firstly, the UK Government has drastically reduced technical R&D to the extent that the expert opinion given assesses that the UK no longer has the technical competence to be able to ascertain whether malware has been secreted in the equipment supplied. Secondly, the wisdom of relying on Huawei to run a Cyber Security check on its own equipment was questioned. Thirdly, control of communications is an issue of national sovereignty; allowing Huawei to gain a dominant market position would jeopardise the UK's national capacity to maintain its own telecom system, to the detriment of national security and sovereignty.

It should also be noted that the UK has only weakly-developed institutions for making national strategy and has not yet equipped its newly-created National Security Council with either the staff or the authority to give confidence in its competence to address such a complex issue.

It is, of course, possible that there exists some highly classified information that contradicts this assessment and which, were it publicly available, would allay these fears. However, in the absence of such information we must conclude that, in their eagerness to encourage Chinese investment, successive UK Governments have taken decisions which may create a security risk. It is interesting to

note that an offer by Huawei to provide a mobile phone system for the London Underground railway system in time for the 2012 Olympic Games was declined - on security grounds.

A Chinese Stratagem to Facilitate their Investments in Europe

Dagong, China's leading credit rating agency, had already made news in 2010 when it unilaterally downgraded the USA, UK, Germany and France from their AAA ratings (and lowered other European countries even further), accusing UK & US competitors of ideological bias in favour of the West.

In 2011, Dagong announced that it would set up a public and regulated (i.e. subject to open official scrutiny) European operation, with Italy (Milan) being their entry point, and with Frankfurt subsequently being chosen as a location for a second entry point. Dagong teamed up with Mandarin Capital Partners, a Chinese-Italian private equity fund, devoted to "exploiting synergies between Chinese production capabilities and Italian/European know how and brands."

In fact, Mandarin Capital is a vehicle to help Chinese investors to invest in the European market, and it has recently become clear that this new Italian joint venture has actually been set up to operate below the radar, assessing and rating companies privately, not publicly. Dagong is estimated to be concentrating on the €1-5m band, giving private assessments to advise Chinese investors as to whether an investment – e.g. as a (cheap) loan or to buy the company in part or whole - is a good or a bad bet.

In doing so, Dagong are exploiting a loophole in European legislation which allows them to operate unlicensed and unregulated as long as they only provide information on each case to one single investor. They need no consent or approval from any Italian or EU agency (e.g. ESMA, the regulator for European credit agencies) and are not required to disclose any information about their operation.

Not only is this very much against the spirit of the rating and regulating system, and opens up the spectre of an alternative market developing which evades regulation, but it is particularly significant in the light of the current financial situation in Europe in general and in Italy in particular.

Firstly, when an agency does a rating of a company they get access to all the activities, private processes, procedures, policies and accounts of that company. They can take copies of everything; nothing, no technical invention or procedural innovation, is secret.

Secondly, Italy is an attractive target area³. Many companies which in UK, for example, would be public, in Italy are private. With a public company, acquiring over 14% must be made public. This does not apply with a private company. Moreover, during the current crisis the Italian Government, in order to improve its financial performance figures, has been delaying payments on contracts for work done (e.g. infrastructure projects) - often for many months. A quarter of all Italian SME's are

³There appears to be a larger policy of capacity-building in Italy and establishing a major Chinese presence. The number of Chinese migrants in Italy has sharply increased over the last two decades

owed money by the Italian Government⁴. Longer delays are further explained away by “imminent elections” or there being “no government in place”.

This policy has, naturally, created great difficulties for some very good Italian companies. Italian Banks are reluctant to give them loans. They are therefore very vulnerable to offers from Mandarin Credit Partners to provide loans or buy equity. Subjecting themselves to an invasive rating scrutiny seems, to the company concerned, less damaging in the Italian domestic environment if that scrutiny is private.

This operation combines all the best features of a tactical operation with a strategic impact. It allows for very cost-effective information gathering coupled with ensuring commercial advantage. The operations of Dagong/Mandarin are legal, but invisible. As with other Chinese commercial operations, such as Huawei, the “face” of this operation is European. High quality companies can be milked of their secrets and bought into without the public being made aware. Many companies, neglected by their own government and banks, are even grateful for the attention and “help”.

Chinese Moves to Develop an Alternative Global Financial System

If investment is a tool of strategy, then the financial system which shapes the environment in which that investment is made is doubly important. China sees clearly that finance is one of the most powerful tools/weapons of hypercompetition. The USA understood very well how important finance would be in underpinning its global position, setting up the Bretton Woods Institutions as a priority after WWII. In the Chinese view, the current world financial system was set up to establish and maintain US hegemony and do away with competitors (the Euro may be an alternative currency to the dollar, but it does not represent an alternative *system*).

It is not surprising, therefore, that China should now be paying great attention to this issue, not only because of its economic significance, but also because it is one of the keys to China’s policy of “de-hegemonisation”, i.e. of undermining the Western dominance of the global economic system. In this context, the development of the renminbi as an alternative global currency is important to the EU politically as well as financially. China understands very well the weaknesses of the current Western financial system, having exploited these weaknesses in the past for Chinese gain.

⁴On 18 March 2013, the European Commission approved the release of €40 Billion for the Italian public administration’s unpaid bills. The Italian public administration, as a result of long payment delays (on average 180 days versus 65 days in Europe in 2012) has accumulated around €90 billion (i.e., 5.8% of GDP) of commercial debt as of the end of 2011, 23.1% of which was owed to construction companies (16.2% of their total production). Companies with 20 to 199 employees owed around half of the total commercial debt. In Italy, one out of four companies declared that they have extended credit to the public administration. These delays have resulted in liquidity stress and revenue loss, especially for SMEs with limited negotiation powers when dealing with the public administration. The Italian situation is particularly negative compared to that of other European countries. The Italian government prepared a decree (that came into force the 9 April 2013) to allow the repayment of almost €40 billion in commercial debts existing as of 31 December 2012 to be paid within the next 12 months.

The renminbi has become an increasingly powerful player in world currency markets. Although not in the public eye, the Chinese have been buying 'debt' on a global basis and are now, for example, the largest single creditor of the USA. China's external debt now stands at \$737bn. In addition to the political leverage which their import and export markets give them (e.g. their economic threats to the UK as a result of the UK's criticism of China's poor human rights record), their global creditor status is also increasingly being used as a political lever.

In the capitalist 'West', including within the EU, some 'levers', such as those related to fiscal policy, have been within the gift or direct control of governments, whereas others, such as the development of trade and the purchase of raw materials, have been outside the control of governments, albeit influenced by their policies. China, with its centrally controlled government and economic systems, is able to manage all of these tools in a central strategic manner and, due to its political system with its 10 year cycle, to develop its strategy on a long term basis rather than on the four to five year basis dictated by the electoral cycle common to democracies. The China of the future is going to want to attract the financial power of the West. It is preparing for this by buying up Western and third countries' assets and debt.

Recognising the challenge from China, the US government has long pressured the Chinese government not to peg the renminbi to the dollar and to agree to a managed float of the renminbi based on a basket of major foreign currencies. This resulted in a 25% rise in the value of the renminbi against the dollar between 2005 and 2011.

China, in response, has repeatedly pushed for the phasing out of the dollar as the international reserve currency and proposed that a basket of currencies should replace the dollar. Some World Bank experts expect the dollar to lose its position as the main international reserve currency by 2025.

The use of financial levers should be seen in conjunction with China's attempts to gain greater control of world supplies of key minerals and other strategic assets, such as water and ice. China's rapidly developing relationship with Argentina, and the decision to underpin the Argentinian Peso provides a good case study. Furthermore, the main competitor to the renminbi in Latin America is now, as in most other parts of the world, increasingly the EU and the euro, rather than the US and the US \$. These developments therefore have a direct impact upon the EU both economically and, in the longer term, strategically and politically.

China's strategy to counterbalance the USA and the dominance of the Western system has recently led it to mobilise the BRICS bloc (Brazil, Russia, India, China and South Africa) as allies. Once a loose political affiliation, the BRICS bloc is now a serious economic contender in the world economy, representing 40% of the world's population and accounting for one fifth of global GDP. Hypercompetition is at play between the BRICS countries too. China, of course, has problems with certain other BRICS countries, notably India and, to a lesser extent, Russia. India's development of a survivable second strike nuclear capability, and both India and China's development of Submarine Launched Ballistic Missiles (SLBM) and Multiple Independently-targeted Re-entry Vehicles (MIRV) have exacerbated tensions of late. It is all too easy, sitting in Brussels, to compartmentalise issues and look only at, say, economic rivalry, forgetting that the competition still includes very hard security and defence issues. However, so far, diplomacy and strategy have been able to handle the

tensions, clashes and contradictions between BRICS countries and to maintain a balanced relationship so that the group can act coherently to achieve a common goal on issues of mutual interest.

One such issue of mutual interest is that the developing world is disillusioned with the status quo of world financial institutions. The World Bank and IMF continue to choose their presidents from the US and Europe rather than from BRICS nations and the US has failed to ratify a 2010 agreement which would allow more IMF funds to be allocated to developing nations. Leaders of the BRICS nations, meeting at a financial summit in South Africa from 26 to 28 March 2013, concluded that they need to create their own version of the World Bank⁵ The five countries hold foreign currency reserves of €3.4 trillion and need an institution to safeguard this amassing wealth. The reserve will also protect members from short-term liquidity volatility and balance-of-payment problems.

The group are cutting their foreign currency reserves in euro, having sold €45 billion of the currency in 2012, according to data gathered by the International Monetary Fund. After the cut, the euro represents just 24% of the BRICS foreign reserves, the lowest level since 2002 – the year when euro coins and banknotes first entered circulation – and down from a peak of 31% in 2009, according to reports in the financial press.

The question for the EU now to ask is - what is the long-term intent of China's policy? To what degree is China propping up the European economy and the euro or, in reality, is China selling off euros compared to the other BRICS countries, while saying at summit meetings that they are supporting the euro? China may not simply be trying to replace or supplement the \$ with another currency or with the renminbi. China already has a lot of influence on the \$ because of the amount of US debt it holds.

What appears most likely is that China is keen to introduce not another currency, but another *system*, one that allows China to deal with those who do not fit comfortably into the Western system and who are not popular with the World Bank and the IMF. When the World Bank and IMF do deal with these countries, they do so in order to help the US, not to help the countries themselves. An alternative financial system would move profits to Beijing, rather than to London or New York.

Finally, it may be more accurate to assess what we are looking at not just as an alternative *financial* system which China is setting up, but rather as the financial aspect of an alternative *societal* system. Such a system would provide an alternative to the whole western societal "package" – including democracy, rule of law, business practice, individual liberties, etc. as well as finance. China's wooing of countries such as Iran, Venezuela and several African states, all of which dislike the Western system for one reason or another, is based to a considerable extent on this developing of an alternative total system- social, political, economic.

⁵See Euractive: *BRICS countries dump the euro, establish bank*. 2nd April 2013
<http://www.euractiv.com/euro-finance/brics-countries-dump-euro-establ-news-518825>

China is not the only player in this field. Russia, for example, has already gained influence in neighbouring countries and further afield by exporting its alternative model of business practice to that model established and maintained by the West. But China's model has been developed faster and more comprehensively than any other, and continues to advance and grow.

8. The Military Dimension of EU-China Relations

Military issues do not normally rank very high in a study of EU-China relations⁶, not least because China and the EU are a long way apart and because, in the EU, Defence is not an issue on which the Member States defer to Brussels. The existence of NATO, and the long-held assumption by European countries that they could rely indefinitely on US military presence in Europe and the Middle East as a guarantor of security, have meant that the EU has not developed a military capability and competence commensurate with its political and economic achievements.

Indeed, the culture in the EU institutions, as in much of mainland Europe, is anti-military. The EU was set up after WWII specifically to prevent Europe's traditional lethal rivalries from replaying 1914 and 1939. Most Member States' experience of the 20th Century demonstrates the folly of relying on military might as the main agent of national security.

This now presents something of an issue for EU-China relations. China's Defence Budget has risen at over 10% per annum for some two decades. With its approximately €77bn official Defence Budget, some 2% of its GDP, China is today the world's second largest military spender. But this budget is misleading. Hidden costs would make the real figure a good 50% higher. More importantly, because costs are so much less in China, €77bn buys *several times* more combat power and force projection capability and capacity than it does in an EU Member State. With this budget, China has been able to build a formidable military strength.

Moreover, China is learning fast how to use its military strength to best effect. It does not see military strength as its main tool of power (as, for example, the USSR did during the Cold War). Rather the armed forces are seen as just one of China's sources of power, one of many strategic tools the country possesses, and clearly a tool to be used with care. By contrast, the EU's inability to provide itself with a credible military implement of any significant size diminishes the EU in Chinese eyes as a global actor. Put bluntly, China has less respect for the EU because it does not have an Army with which to back up its diplomacy, recalling Prussia's Frederick the Great's dictum: "Diplomacy without arms is like music without instruments."

As noted above, this is a tool the Chinese have designed to be used, and herein lies the second issue for the EU. The recent Chinese White Paper on defence makes it clear that, in addition to the roles of territorial defence, internal security and supporting national development, the military is also tasked with "providing reliable security support for Chinese interests overseas". The Chinese military's ability to evacuate 36,000 of their nationals from Libya was a very impressive demonstration of this resolve. The EU Member States together, with over double the Chinese defence spending, would have found it difficult to launch an analogous operation so efficiently off the coast of China. The Chinese also understand that their Armed Forces are not only an "insurance policy" but an investment. Moreover, they are an investment which will enable China to exploit opportunities in the national interest as well as protect against threats. This is an attitude which EU Member States would do well to learn themselves. It might result in a better appreciation in Europe of the value of

⁶ The PLA's involvement in Cyber warfare and in commercial companies is addresses in different sections of this report.

investing in military forces in peacetime, and of how such forces might be structured, trained and equipped.

As China builds up its military *capabilities*, it is also taking care to build up its military *capacities* too, something Europe on the whole neglects to do. This means that, if China feels the need to defend sea lines of communication, or protect its investments or its diaspora population anywhere in the world that they are threatened, it will have sufficient military assets to do so and it can afford to take losses in any combat that follows its deployment. China's global military presence is demanded by China's global political and economic presence.

The EU must, therefore, begin to consider for the not-too-distant future the possibility that its Member States will see far more Chinese military presence in areas where it has not been seen before. Any future conflict of interest between China and Europe may come rapidly to have a military dimension. This must particularly be expected in areas such as the Gulf, and the evaluation should also take account of the strong possibility of a US military drawdown as the US' energy independence grows, as discussed elsewhere in this report. The EU and Member States should consider carefully how they might respond to a US-China military clash if the US asks for European support.

These may not be issues in the forefront of people's minds today but, given the time it takes to build up military force, now is the time to start thinking seriously about this issue and to study alternatives. This will be a long and difficult haul for the EU and for many Member States. Some serious thinking needs to be given to the issue now.

Defence Sales & Exports - The Developing Chinese Challenge to EU Markets













An area where Chinese "military activity" does immediately impact on the EU and Member States is defence exports. These have both an economic and a political significance, because they are a significant tool of China's global strategy. Increasing Chinese involvement in the Defence Sales Sector impacts directly upon the 'West's' political relationship with the developing world, on regional balances of power, and on global stability. It also represents an economic and employment threat to the EU. Furthermore defence sales may be used as a way of further indebtedness and tying already dependent states closer to China⁷.

China's global defence exports currently rank third in the world. As with the United States and Russia, which have 30% and 26% of the global arms export market respectively, China's exports are not matched by her defence sales, where she is currently ranked fifth. However China's defence sales rose by 162% in the period 2008 – 2012⁸ in a declining global market⁹ and against a background of declining defence sales across the EU.

⁷ E.g. China's single largest defence export customer is Pakistan and many of the purchases made by Pakistan are funded by 'soft' Chinese loans.

⁸ Fuelled in part by the arms race on the Indian sub-continent and where China is now Pakistan's largest source of arms.

⁹ SIPRI Press statement 18 Mar 2013.

2001–12 ¹⁰ Rank	Supplier	2001 ¹¹	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
1	 United States	5908	5229	5698	6866	6700	7453	8003	6288	6658	8641	9984	8760
2	 Russia	5896	5705	5236	6178	5134	5095	5426	5953	5575	6039	7874	8003
3	 Germany	850	916	1713	1105	2080	2567	3194	2500	2432	2340	1206	1193
4	 France	1297	1368	1345	2219	1724	1643	2432	1994	1865	1834	2437	1139
5	 China	499	509	665	292	303	597	430	586	1000	1423	1354	1783
6	 United Kingdom	1368	1068	741	1316	1039	855	1018	982	1022	1054	1070	863
7	 Italy	880	191	526	314	538	432	366	454	383	806	1046	847
8	 Israel	203	239	342	209	583	1187	1326	530	545	503	531	533
9	 Sweden	216	426	341	212	774	502	684	417	514	806	686	496
10	 Ukraine	700	311	442	200	290	553	728	330	320	201	484	1344
11	 Spain	7	120	150	56	108	843	590	610	998	513	927	720
12	 Switzerland	193	157	181	243	246	285	301	482	255	137	297	210
13	 Canada	129	170	263	265	226	226	334	227	169	258	292	276
14	 South Korea	165	N/A	100	29	48	94	220	80	163	95	225	183

Chinese Defence Manufacturing Capability before 2002

This period was characterised by the import and local manufacture of generally obsolescent equipment from the Soviet Union. As time progressed, much of this equipment was indigenously improved and produced in large quantities, some of which was subsequently exported. Manufacturing standards were low and in general the equipment was poor in any areas which required those high-grade, highly technical systems which China could not produce domestically¹².

¹⁰SIPRI yearbook 2013.

¹¹All values are expressed in millions of US \$.

¹²China exported a large number of locally made MIG-21s to Albania. Not only were the avionics inferior to those fitted in the Soviet made MIG-17s with which the Albanians were already equipped but part of the

This was noted and widely commented upon by potential importers¹³ but the relative cheapness of such equipment made it an attractive option for third world countries in conflict, or those who needed large amounts of defence equipment¹⁴ but otherwise could not afford to purchase it.

China also showed itself willing to export weapon systems which other states would not countenance¹⁵ and regardless of regime type. Although much of the equipment was produced in some quantity, in the naval area in particular, as with the Jianghu class of frigates, they were required to assist in the build-up of the People's Liberation Army's Navy (PLAN) and it was not until the 1990s that these ships were sold for export¹⁶ with arrival of more sophisticated units embracing Western technology into the PLAN.

From the mid-1990s, and with the ability of China to acquire more sophisticated Western European technologies, there was a marked improvement in the quality and construction standards of the more sophisticated weapons systems, such as warships and combat aircraft. The emphasis in terms of production switched from quantity to quality with the inevitable result that the volumes of this newer equipment available for export declined. In the late 1990s, the Chinese again began to build improved versions of Russian combat aircraft, in particular the J-11 which was a licence built version of the SU-27 'Flanker'. These aircraft were designed as direct competitors to the US F-15 and European Tornado/Typhoon aircraft.

The Chinese Defence Industry and Sales from 2002 to the Present

In addition to the more obvious nuclear submarines, a renovated aircraft carrier and various missile programmes of increasing sophistication, China has developed as a power house of technological development in the electronics area. Notable developments in electronic warfare and in 'over the horizon radar' so as to support - amongst other things - China's own indigenous cruise missile systems, have been complemented by the development of UAVs and attack helicopters.

In the naval field, the Jiangkai I type 54 Frigate built from 2002 is a direct competitor to Western European ships, such as the Royal Navy's type 23 frigates and the French 'Lafayette' class upon which it may have been based. The latest generation of Chinese multi-role warships benefited from access to French engines¹⁷, gun and avionics technology. Jiangkai I was replaced in production in 2007 by the Jiangkai II class which, while it retains its 'stealth' features, benefits from a much improved information system and from the merging of the hull with a gun system originally of

agreement was that in return for the new aircraft Albania would 'donate' sixty of the Soviet made MIG-17s to China.

¹³ The Bangladeshis in particular were critical of their Chinese produced warships. They were also highly critical of those produced by South Korea at around the same time.

¹⁴ In particular small arms, small arms ammunition and artillery ammunition. In the mid-1990s the cost of Chinese ammunition was often in the order of 10% of that of equivalent amounts of Soviet ammunition, with second hand East German ammunition being at a higher premium still.

¹⁵ China exported Mustard gas and Phosgene (World War One era chemical agents, but still effective) to Albania, for example.

¹⁶ Customers included Bangladesh, Egypt, Pakistan, Myanmar and Thailand, with a total of eleven frigates being exported. Domestically China has transferred at least four of the remaining hulls to the coastguard.

¹⁷ Initially built under a licensing agreement from France.

Russian origin¹⁸. China now not only has the capacity to produce enough warships and aircraft for her own rapidly growing Defence forces, but also for the first time to export latest generation equipment simultaneously.

China is currently exporting three Jiangkai II frigates to Thailand along with six Zennec helicopters for a total price in the region of one Billion US dollars¹⁹. This is a significantly lower price than can be achieved by any Western European manufacturer without recourse to domestic government aid²⁰. China is also exporting both Jiangkai I and II to Bangladesh²¹ and Pakistan²² thereby significantly altering the balance of power in the Indian Ocean.

Along with the increasing sophistication and reliability of its equipment over the last ten years, China has demonstrated that the equipment that it has delivered to the PLA, and in particular the PLAN, is robust and efficient. A good example is the participation of the PLAN in the anti-piracy patrols off Somalia, where China has demonstrated both the sea-going capabilities of the Jiangkai I and its associated rotary-wing equipment and the multi-role capability of the frigate in mounting opposed boarding operations etc. Not only are these 'international' actions effective in a political sense, but they have also demonstrated to potential customers that they can afford a blue water navy and an air strike force with a supplier willing to sell them equipment without asking too many questions about their domestic political activities.

The Impact on the EU

In the short to medium term, the impact of the increasingly aggressive Chinese Defence Sales campaign backed by soft loans may well be primarily to disadvantage those small and medium size states within the EU whose less sophisticated defence manufacturing industries are directly in competition with those items which the Chinese are willing and able to export now. Spanish manufactured Frigates and Sloops are a good example of an area where the Chinese are already in competition in the market with a sophisticated competitor hull based on that of a modern Jiangkai II.

In the medium to longer term, this switch of emphasis to high quality, high volume, low-cost defence production will particularly affect the larger EU states with the most developed defence manufacturing capabilities and the most sophisticated defence technological base, such as the UK, France, Germany and, to a lesser extent, Italy. China is already dominating the Pakistani export market in the Land, Air and Sea environments. It is pushing strongly to secure a similar dominance

¹⁸ The change in weapons system was so as to improve anti-aircraft defence. As with the Indian indigenously constructed 'Delhi' class of guided missile destroyers (DDG) the Chinese have been successful in marrying together the best of Western European and Russian technologies and systems into one hull.

¹⁹ *Defense News* 2nd February 2013 and other Defence journals.

²⁰ Across the board for the larger systems such as combat aircraft and major surface vessels the Chinese are able to offer comparable, if in some cases slightly inferior capabilities for between 30 – 40% of the typical Western European sales price. In the case of Armoured Fighting Vehicles (AFV) this 'discount' increases to about 15 – 20% against Western European systems and to perhaps 40% compared with systems produced in Russia or by tertiary suppliers such as Turkey.

²¹ A further probable customer is Algeria.

²² It is delivering three Jiangkai I, with a further hull being built in Pakistan and there are two Jiangkai II on order.

over the Malaysian and Thai markets and to enter the Indonesian market. Further afield, it is expanding its defence sales into Latin America, where it is already present in Venezuela and may look to expand its foothold in Argentina and where any long overdue investment in combat air power and maritime platforms will significantly alter the balance of power in the region²³.

In the 10 – 15 year medium term timeframe, as the bulk of the equipment which is being delivered to the PLA is replaced, China will also be in competition with (and significantly cheaper than) their EU counterparts in the offer for sale of 'part-used' but still capable defence equipment across the whole spectrum of defence sales.

Defence Exports in the top six defence exporting countries within the EU totalled in excess of 4.4 Billion US dollars in 2012, a drop of 26% compared with 2008, compared to a Chinese increase of 162% over the same period.

Moreover the chances of Spain and Italy being able to 'sweeten' major defence exports with soft credit loans are becoming less likely as their economic situation within the Euro zone constrains their room for manoeuvre.

How Chinese defence sales could affect Regional Security

Even the limited Chinese defence sales prior to 2002 have already had a significant effect upon global conflict. In conflicts close to the European periphery, much of the artillery and multi-barrel rocket ammunition used by the Georgians in their recent conflict with Russia was originally supplied by the Chinese in the 1970s and 1980s to Albania. Some Armenian artillery and mortar ammunition has a similar provenance, as do some of the weapons and small arms ammunition used by the PKK and Hezbollah.

Moving to Latin America, whilst Argentinian rhetoric with regards to the Falkland Islands may be bellicose, the finances of the state are in no way capable of adequately re-equipping the Armed Forces to a level which might present a credible military threat, given the cost of Western European or US equipment to replace its ageing combat aircraft, helicopters and warships -now in many cases over thirty years old. Chinese equipment may, on the other hand, be affordable, so that at least such a hard military capability could be 'grown' over time. This will be particularly so, for a post-Kirchner and perhaps more militarily sympathetic Argentinian President especially if, given the scale of Argentina's food exports to China, it were to be funded through some kind of barter arrangement coupled with 'soft loans'.

Chinese exports into the Middle East and some parts of Africa have transformed defence capabilities and indicated to some states, such as Iran, that there is a viable alternative to that of obtaining military hardware from the US, Western Europe or Russia across the whole spectrum of defence. The Chinese sale of CSS-3 anti-shiping missiles to Iran significantly altered the strategic picture in the straits of Hormuz, through which a significant part of the oil for Europe flows, as did the sale of similar systems in the Red Sea. The sale and proliferation of Chinese hand-held Surface to Air Missile

²³ Not solely in terms of the Falkland Islands but also in terms of Argentina's aspirations to be a regional power and hence with Chile and possibly even Brazil.

(SAM) systems into Africa and elsewhere, some of which have now 'leaked' into the hands of armed groups, has significantly altered the threat to Western European interests in the region.

Combined with defence hardware, China is also developing a very creditable track record in the provision of defence infrastructure, with the construction of naval bases, airfields and Information and Communications Systems (ICS). These developments are often very difficult to measure in economic or indeed military terms, as are the strategic impacts of highway building and rail construction, but do now ensure that China is a direct competitor with European companies in this significant area of business.

Conclusions

Measurement and calibration of Defence Sales versus Defence Exports has always been a difficult science. This is particularly so in the field of defence infrastructure. Where does civilian infrastructure enhancement of an airfield or highway building programme become a defence project? South Sudan provides a good example of this phenomenon.²⁴

Increasingly, China is defending its other investments, e.g. in minerals etc. in turbulent areas of the world, particularly in Africa and, increasingly, in South East Asia and Latin America by arming the regimes in those areas where its other commercial interests lie. China is interested in maintaining the stability of those regimes regardless of their nature, so as to protect its supplies of minerals and other scarce strategic assets²⁵. If it can do so by bolstering its own defence sales in the process, and by ensuring that those states increase their dependence on them, then it will do so.

Chinese defence sales thus threaten not only the European defence sales market, but European political and commercial influence in large parts of the third world and within the last decade have significantly altered the balance of power. Additionally, by providing a fourth supplier²⁶ of defence equipment across the whole defence spectrum, they have irrevocably altered the relationship between states in the third world and their previously exclusively European or US suppliers. Hence the increase of Chinese defence sales and exports at the expense of the 'West' threatens not only 450,000 jobs across Europe in an industry worth 7.2 Billion US dollars²⁷, but also the EU's continuing ability to influence politically and economically, other than through the mechanism of economic aid²⁸. As recent conflicts have graphically demonstrated, aid is an influencer, but not a determinant, of conflict. Access to affordable weapons and defence technology often is.

Finally, the steady EU disinvestment in Defence and the de-industrialisation of several major Member States has reduced the capacity for the EU to compete in the use of Defence equipment acquisition and supply as a tool of power and influence. Similarly its Framework R&D programme –

²⁴ As a principal investor in the oil industry in South Sudan, China has a legitimate interest in developing and improving the road and other infrastructure, however such improvements also bring military benefits to the regime concerned.

²⁵ In line with the 'String of Pearls' theory articulated in the last decade.

²⁶ The others being Western Europe, the USA and Russia.

²⁷ Defence Exports from the six largest defence materiel producing states within the EU in 2009; Germany, France, the UK, Sweden, Spain and Italy.

²⁸ Of which the EU and its Member States are by far the world's single largest source.

the World's largest – has largely excluded Defence technologies, accelerating the decline of this tool of power.

9. Organised Crime

Chinese organised crime in the EU is a clear security threat, just as is organised crime of any sort, whoever controls it. This is an issue for the EU and Member states' law enforcement bodies; their professional competence and recommendations as to the tactical responses necessary cannot be bettered by the authors of this report. What this report can usefully attempt is to highlight certain aspects of Chinese organised crime as it might pertain to other aspects of China's relationship with the EU, allowing it to be taken into consideration when the EU is considering its strategic response to China.

China is the main source of counterfeit goods entering the EU, and this traffic is the main trade of Chinese organised criminal groups. The recent economic crisis has increased the attractiveness of these counterfeit goods and customer tolerance has risen accordingly. This has a negative impact on legitimate trade and on resources available for R&D within companies.

Chinese counterfeit goods are produced to a high quality of mimicry, but where the content, as opposed to the appearance, is important (such as with illegal drugs, pharmaceuticals or pesticides) their poor quality is often dangerous to health. Consequently, this crime is not only a threat through lost tax revenue and intellectual property rights, but also through its impact on human security. The impact on human security is increased in those areas where gangs are strong as, with their increased wealth, they can come to control whole areas of a city.

The main entry routes are through Mediterranean ports, which may create an interesting situation as the Chinese buy, or make major legal investments in, such ports (e.g. Piraeus and Naples). Importation involves the Chinese groups in collaboration with local organised criminal groups, such as the Camorra, both to facilitate entry and subsequent distribution throughout the EU²⁹. Although in contrast to past practice, collaboration with other groups is now increasing, the first distinguishing characteristic of Chinese organised crime is that, Chinese criminal groups base many of their activities within the Chinese communities in the Member States.

It is this capacity for insularity which makes Chinese organised crime difficult for law enforcement agencies to tackle because the gangs can enforce a tight security. It also gives criminal groups the potential for control within diaspora communities, where the Chinese tendency to self-isolation also makes the communities difficult to police. This situation has created within many Member States where the Chinese diaspora community, sometimes of long standing and having good relations with the mainstream host society, could become the vehicle for illegal Chinese intervention (e.g. for espionage, subversion, or merely political lobbying) in event of crisis or conflict. We would not wish to exaggerate this likelihood, but it must be taken into consideration. The recent growth in immigrant Chinese communities as a result of Chinese state policies, and the growth of illegal migration run by the criminal groups themselves, could serve to increase this possibility.

²⁹ Chinese counterfeit goods and illegal migrants are also entering Europe through Serbia. This is a left-over from the days of the Milosevic regime when there was a financial trade-off for allowing Chinese access. Albania is a second potential source of Chinese activity given the longstanding links with that country.

The second distinguishing feature of Chinese organised crime is that its leadership remains in China and its profits are exported to China. Not only does this naturally make it difficult for Member States law enforcement agencies to track down and arrest the masterminds and seize the money, but cooperation with the Chinese authorities is complicated and often very difficult. This raises the suspicion that some of these criminal enterprises may be protected and their operations facilitated by individuals serving within the Chinese State apparatus. Although this does not mean that the State endorses their activity, it does open the possibility that, in some circumstances, the State could make use of these criminal groups to reinforce its policy towards a Member State.

The third distinguishing feature of the groups is that they are highly flexible and adaptable. In this, they reflect the same characteristics that we see in Chinese mainstream, legal business and in the workings of Chinese official policy. They are very quick to recognise changes, threats and opportunities in their environment and react accordingly. As a result, they are very successful criminals. They are most adept at exploiting loopholes in the law; at changing their products, trafficking routes and other procedures in response to actions by the law enforcement agencies, changes in visa regimes, legislation and the like. As with other organised criminal groups, the Chinese groups are increasingly making use of legal business “fronts”, blurring the lines between their legal and their illegal activities.

It is this last feature of adaptability in particular, which makes it difficult for law enforcement agencies to succeed on their own in the fight against Chinese organised crime. Tactical solutions, however clever, will not work as they can always be evaded and outflanked in a democratic society. What would make an important difference would be to consider the fight as an integral part of the EU’s strategy for dealing with China and to include a strategic response in the package of measures that might constitute that strategy.

As things stand, Chinese organised crime in the EU presents no real threat to Chinese official policy. No-one is suggesting that the crime is officially sponsored; the profits return to China; the impact on the EU serves to weaken China’s actual or potential competitors; and, in the event that China’s relationship with the EU or with individual Member States should sour, the groups might even be capable of being harnessed for use to serve State ends. It is not surprising, therefore, that EU law enforcement agencies find it difficult to generate enthusiasm amongst Chinese officialdom to collaborate to put a stop to the criminal activity.

However, historical precedents in other areas would suggest that, whilst the Chinese authorities might not be responsible for facilitating organised crime operating from their territory, they would most certainly be able to do more to prevent it if there were sufficient motivation. Providing that motivation by way of making this a condition for advancing some policy that China wanted would be a sure way of making life more difficult for the leaders of the gangs resident in China.

10. Cyber Security

The Cyber Threat from China

It has been well established by many competent sources that the EU's and other Western state and commercial bodies are being subjected to constant cyber-attack from China. The recent "hacking scandal" highlighted in the Mandiant Report³⁰, and the publicity given in the Western press to Chinese cyber-attacks generally, are not strictly speaking "hacking" issues at all. There is hacking, as well as criminal and corrupt IT practices on a significant scale. But this must not be allowed to obscure the fact that we are seeing an element of China's large scale "competitive intelligence" operation, which is discussed above - itself an integral part of China's co-ordinated strategy for re-establishing its place in the world.

Today in China, "state intelligence requirements" and "gaining commercial advantage" are not separate issues, but "two sides of the same coin" (This may not remain the case in the future as China evolves, but it is so at the moment). The "cyber operation" is but a piece of the larger *Hypercompetition* jigsaw puzzle. It is essential that we recognise this and understand precisely what is happening if we are to respond appropriately. The Chinese are not simple opponents creating a threat. What they are seeking is not necessarily destruction, it is *advantage*. They want the EU in being in order to exploit it. Cyber is simply one means of doing so. It can only be understood if it is seen in combination with the other means of gaining advantage, and in light of that particular motive.

Chinese software cities were created in the 1990s, partly to build up an indigenous software capability and capacity to break the country's dependence on western software (limiting computer use to English-speaking Chinese), partly to understand how systems were protected and to develop the art of protection and attack. To improve its *hypercompetitiveness*, China had introduced, firstly, a mass English-learning programme, today reaching some 300,000,000 people. Secondly, a mass programme to teach computing was undertaken. The ability to engage in Hacking or cyber-warfare is not, therefore, limited to a handful of people. The principle is the same as that which inspired the UK's WWII code-breaking and cryptography effort, but on a mass scale, and includes the aim of identifying and recruiting capable people.

Although the Mandiant report identifies a PLA recruitment process from universities, the best hackers are unlikely to be created by giving civilians or PLA soldiers an aptitude test, selecting the best and creating a team. That would produce quantity (always useful) rather than quality. The way to get the best is to scan the net for emerging, self-identified and self-taught "unethical" hackers, then to approach the individuals directly and clandestinely.

Currently, the Chinese state monitors all e-traffic and social nets to restrict popular expression of opinion. This, coupled with the expertise assembled in the software cities, enables them to identify and track down "unethical hackers", often teenagers, as these emerge and mature naturally. These hackers, once located, are approached directly by the authorities with "an offer they can't refuse" to join the PLA cyber operation. This provides them with a safe space, rewards them, fosters their

³⁰ <http://intelreport.mandiant.com/>

talent and monitors them, harnessing their skills in the service of the state whilst at the same time protecting the state from their activities.

This process has been going on now for some twenty years. By Western expert estimates, the Chinese have, as a result, a 5-7 year advantage over the US and Europe in the practice of harvesting and using such domestic talent and harnessing it to state objectives. Nor are all Chinese hackers and cyber-warriors necessarily in China. The huge Chinese academic presence in many countries, worldwide Chinese commercial activities, and the many Chinese diasporas, all provide potential resources to contribute to this co-ordinated effort. It also adds to the difficulty of identifying the real origins of a cyber-attack, which complicates the problem of deterrence through the guarantee of retaliation.

In the light of this, it is futile for US or EU authorities to call on China to “curtail its hacking activities”. Were China to claim that it had dismantled its domestic teams and, instead, dispersed them to operate in small groups, this would certainly make their job harder. But it would also make it much more difficult for western experts to identify the cyber activity, as they have done through the huge server farms that have been created to run the present system.

If China were to break up its cyber teams and make them redundant, these experts would revert to hacking against Chinese targets. It is in the nature of a hacker to hack, if not for the government, then for himself or herself. Technology is accessible and permeable, even in China. The threat will never go away. The Chinese authorities could never control all these individuals if they were dispersed. The choice for the Chinese is to have hacking state-controlled or independent. As it is, the Chinese have found a neat solution, turning a domestic problem into a state asset.

Notwithstanding the above, it is also evident that not all Chinese hacking is part of a coherent state strategy. The evidence presented by various reports indicates that: (a) some incidents do not fall into any of the patterns presented by the Mandiant and other Western reports; (b) different parts of the Chinese system are involved in the activity competitively. Given the fact that the point of origin of such attacks cannot always be determined with great accuracy, the key question is which of these activities are actually carried out by Chinese state institutions. Major Chinese corporations have their own interests; state control of or influence on these corporations is not total, and may indeed be lessening as China develops.

In some of these causes (e.g. attacks on German government institutions), it is not clear why China as a state would want to risk its expanding relations with Germany for the sake of a temporary tactical success. If anything, the opposite should be the case. Moreover, some of these attacks have had exactly the opposite effect from that intended, and serve to alert us to a problem. What is not clear is the extent to which rivalries among Chinese state and non-state entities (e.g. large corporations) is leading them to engage in activities which are likely to compromise China as a state, while improving their relative power position within the Chinese state apparatus.

For example, China and India are not the best of friends, and the Indian “default setting” is to judge every initiative from China which affects India as state-sponsored. There has been a recent scandal in India concerning the large scale flooding of the mobile phone market with cheap Chinese phones with no IMEI numbers on them, making them virtually untraceable. Although the Indian government has been putting strong pressure on the telecom companies to prevent the sale of

these handsets, many of them are now in the market and pose a clear security problem as they could fall into the hands of militant/terrorist groups. If these phones fall in to the hands of such groups within the wider region, which target Europe and European interests, this could be an actual threat to European internal security.

There is no evidence that this has any official backing/direction from Beijing. On balance, it is more likely to be collateral fallout from Chinese economic activity in the region, and the uncontrolled proliferation of cheap technology. But, whatever its origin, it is an economic threat and it is potentially a serious physical security threat. It underlines the difficulty the EU faces in dealing with China in general, as well as on the issue of IT and hacking. Whilst there is a high degree of coherence in Chinese strategy, this coherence is by no means total, and this fact complicates our response.

Planning and Implementing an EU Response to Cyber-attack

A response *is* necessary because most individual Member States cannot fight this threat effectively on their own. If left unchecked, China could eventually undermine the commercial viability of the EU and even gain control of key infrastructure or assets in Member States, one at a time. Like any tool or weapon of competition or conflict, cyber naturally seeks out weaker targets. Constant probing establishes areas of competent defence and those that can easily be penetrated. In this way, cyber can be an element of “splittism”, of exploiting the weaker Member States and accessing EU targets through them, of dividing the EU against itself.

Indeed, the publication of the Mandiant Report - which spurred the current spate of interest in the cyber threat from China - indicates that this is a problem which even the USA cannot solve on its own. The Report says nothing new, it simply gives detailed information about a long-standing issue. It was published at the instigation of the US NSA under pressure from, inter alia, major US corporations, which have been suffering a great deal from the Chinese attacks. It is a call to arms; a call for allies. It provides an opportunity for the EU to co-ordinate, or even to collaborate, with the USA to tackle the problem.

As with all complex issues, there is no quick solution, no “silver bullet”. This is not something which the EU can stop happening (unless we are prepared to expel all our Chinese visitors and cut ourselves off from the global communications network). The EU’s leadership would find it difficult, if not impossible, to make a comprehensive policy response. Consequently, a very serious initiative is now needed which will study and understand the problem in detail and which can assess what is within the capabilities and capacities of each element of the EU to do. This will enable a series of practicable measures to be identified, some of which can be put in train by the European Commission, others by Member States. This, in turn, is likely to require the EU to use, and where necessary to strengthen, its own internal mechanisms and to improve communication with and between its Member States.

In addition, it will be essential to work with commercial companies operating within the EU, taking into account their commercial and financial interests. This will involve other countries, and is yet another excellent example of why the EU’s security cannot be split neatly into internal and external packets. Today, many European firms out-source their IT related and call centre related operations

to India. At the same time there is an apparent cadre of Chinese hackers targeting India (some reports have indicated a large group at Hainan Island. The level of official sanction remains unclear). This could point to an insecure operating environment in India for European companies, with a direct impact on the EU's internal security.

11. Education

Education is one of the most potent forms of power in any society, although this is forgotten regrettably often as countries become affluent. The Chinese have not forgotten it. They have, moreover, a particularly strong philosophical tradition which is the backbone of their culture and which, in many ways, has played in China the role which religions have played in shaping societies in Europe and the Middle East. This philosophy in large measure underpins the very great differences between Chinese and Western thinking and behaviour.

For much of the past few hundred years, Europe has been the dominant cultural exporter to the rest of the world, through its political and economic empires. This export has long been seen as a direct threat to Chinese culture, and at times has elicited a visceral reaction. Much of recent history has seen Chinese attempts to protect their culture from foreign influence. These efforts have had a degree of success. Today, although there is still work to be done, the Party's reinterpretation of Communism as part of this philosophical history, abandoning the alien ideology whilst keeping the useful procedures, has seen – at least for the time being – a widespread degree of acceptance by the population. A tight social network, and a constant effort to monitor for and to dissuade dissent, helps to maintain this conformity.

Consequently, today's Chinese Government can concentrate on giving its information campaign an external focus to generate the effect they want from this form of power. This is not traditional "propaganda", which repeats a single message to achieve its effect. It is based on the coherent transmission of a single culture. By being transmitted subtly, and through a wide range of mechanisms and sources, it avoids looking like propaganda and gives an impression of a plurality of ideas, rather than different elements of a single set of ideas. Their aim is to change our thinking about China and about the world in a way which makes them more acceptable and appreciated. China is now on the cultural counter-offensive abroad, at the forefront of which are the Confucius Institutes.

The Confucius Institutes

The Confucius Institutes are equated by the Chinese to Western cultural institutes, such as the Goethe Institut, the Alliance Française or the British Council and, in one particular sense, they are absolutely right. These Western institutes reflect and promote the values of the societies they represent. They are not closely controlled by government. They do not push their government's line. They encourage a plurality of views.

The Confucius Institutes are usually careful not to push Chinese Government policy in any crude way, but they are equally careful that everything they do reflects that policy and shows it in a good light. Their work is totally coherent with the government's programme. They promote the learning of the Chinese language – their original *raison d'être* - and that too is an important vehicle for putting across a strong cultural message, generating sympathy for China, improving China's image and extending its diplomatic outreach. They also play a significant role in China's "competitive intelligence" programme, which is discussed elsewhere in this report.

There are currently 390 Confucius Institutes and 519 Confucius Classrooms in 108 countries worldwide, of which 132 Confucius Institutes and 106 Confucius Classrooms are in 34 European countries. Only Cyprus, Latvia and Luxembourg do not yet have Confucius Institutes. The official aim is to establish 1,000 Confucius Institutes by 2020.

Usually embedded in the academic environment of their host country, the Confucius Institute provides a financial reward to the university or school in which they are located. For this they demand editorial control over all work they commission (e.g. papers for publication). This has led Oxford University in the UK to reject the offer to host a Confucius Institute on the grounds that its goals are not academic and its terms would compromise academic integrity. However, in the current financial climate, not a few universities are persuaded to accept the terms, the offer of free Chinese language instruction being too tempting to refuse.

Other Academic Outreach

As briefly noted above in reference to the Confucius Institutes, China's academic outreach programme is a very important element of the country's "competitive intelligence" operation. It is estimated that China has despatched around a million people to work in academic institutions and commercial companies around the world, with upwards of 30,000 students in some major EU Member States.

The essence of this programme is to monitor every research facility in the world, plus all the top national institutions, public and, where possible, private, for material which may in some way be of use to China, now or, where the state-of-the-art work is beyond them, in the future. The Material may be in the form of studies, research papers or procedures (such as effective management methods, production processes etc.). The domains covered are by no means only hi-tech; they also include social issues, leisure and entertainment, governance, indeed anything which might lead to a happier, as well as a more advanced, prosperous or stable China. Developing countries are targeted just as are developed ones, as they too may have good lessons to teach.

In the course of preparing this study, the author has several times met the attitude that "the Chinese are not good at inventing, but only at copying". Laying aside for the moment whether this is, or is not, the case, the fact is that it may well be irrelevant here. Invention (i.e. the creation of something intrinsically new to humanity) is not the same as innovation (e.g. introducing something new to you, to improve your performance). Innovation is what China reckons it needs at this stage in its development, and its academic outreach to harvest the results of others' efforts is the basis of that innovation process.

The process starts with a scanning for available research papers, professional articles and the like, which are useful in themselves and which also indicate which institutions (eg university departments, companies, institutes etc.) and individuals are conducting leading-edge work. High quality Chinese students are then assisted to apply for positions in those companies or institutions, or to enrol, typically, on post graduate degree courses in those departments. It is the task of that student to evaluate the department, and to download or otherwise acquire as much relevant academic research material as is available from that position.

Those institutions judged worthy and appropriate may then get applications from a number of individuals to work or study simultaneously, and for several years. These people learn as a team, and return to China as a team, where they can continue the line of work in an appropriate Chinese institution.

This process is popular with universities, which frequently earn higher fees from students from outside the EU. It is popular with Professors, who enjoy having excellent, hard-working students, and with companies, which benefit from the quality of their new staff. In some cases, China will subsidise the development of some line of work. But, of course, the intellectual value-added returns to China and, especially in the case of universities, the Chinese student displaces an EU student. When China stops sending students to a given cutting-edge research establishment, this will tell us that they think that they have reached the state-of-the-art in this area.

The challenge to the EU and its Member States from China's academic outreach is to understand this for what it is, i.e. an important element of a coherent state strategy of information gathering and influence. This is not in the spirit of the European academic tradition and, as a consequence, many scholars view the Chinese approach naively, refusing to see any ulterior motive. Financial problems in many Member States' education sectors increase this blindness. However, this does not mean that China's academic outreach should be rejected. Properly assessed and engaged with, it can be of great value. But it does require that assessment, monitoring, and the proper informing of those who deal with it. It also requires an understanding on the part of social planners of the long-term effect of Chinese students soaking up the education that would otherwise have gone to students from Member States.

12. The Current Dynamics of the Relationship between Russia & China

The high-profile visit of Chairman Xi Jinping's visit to Moscow (22-24 March) has not produced the kind of breakthrough that will overcome the ambivalences that each country has towards the other. This is a relationship of high (and growing) mutual importance. It has less strategic coherence than appearances suggest, but it is in balance, and likely to remain so. It may be a model for the kind of balanced, mutually advantageous relationship that the EU seeks with China.

Commonalities

Russia and China share a classical (Westphalian) commitment to international law, state sovereignty and a strict demarcation between internal and international affairs. They maintain a 'principled' opposition to (and genuine concern about) 'hegemonism' (code for the predominance of the United States and its allies) and a strong desire to limit US (and Western) influence in Central Asia and wind up the residual US/NATO military presence. They oppose 'unilateral' (US) enhancement of missile defence capabilities in Asia, which they believe is designed to undermine their respective deterrents. (Xi met separately with the Russian Minister of Defence, Sergey Shoigu, a day before the two defence delegations met, and it is likely that counter-measures were discussed). Both regard the US and its allies as ambitious rather than defensive players in the Korean peninsula and believe that a joint failure to resolve the nuclear impasse would be preferable to a 'unilateral' (US/South Korea/Japan) 'solution' (an assessment wisely or rashly underpinned by assessments that North Korea is 5-7 years away from an operational nuclear capability).

Both Russia and China are troubled by the implications of NATO's withdrawal from Afghanistan and share similar anxieties with regard to the spread of *jihadism*, the drugs trade, the synergy between them, and their potential interaction with separatist and 'extremist' movements in China and Central Asia. In response, they will respond by the usual top-down methods, endeavouring to enhance bilateral cooperation as well as the collective capacity of the Shanghai Co-operation Organisation (SCO) - and, by Russia, of the Collective Security Treaty organisation (CSTO), of which China is not a member. But Russia, China and other regional players are poorly equipped (intellectually and materially) to reform demoralised border/customs services or to address the malign synergy between incompetence, distrust and corruption of authority at local level.

Trade is an increasingly positive factor. Turnover (\$88 bn in 2012) is 2.5 times the 2009 level, and Putin and Xi 'pledged' that it will rise to \$100 bn in 2013 and \$200 bn by 2020. But its importance is grossly asymmetrical. Whereas China is Russia's second largest trading partner after the EU (\$400bn 2011), Russia is a poor sixth amongst China's partners (compared to EU's \$567 bn and US \$447 bn in 2011), and is just ahead of India.

Energy supply, which will be 'prioritised' in future, is of central importance to both parties and critical to Russia (especially *Gazprom* for whom Asia is the sole potential driver of future growth). *Rosneft* and the China National Petroleum Corporation (CNPC) appear to have agreed an \$8-10 bn contract for 9-10 mn tonnes p.a. of Russian oil through the East Siberia-Pacific Ocean pipeline (ESPO) between now and 2020 (vs. 15 mn tonnes p.a. forecast in 2009), whilst *Gazprom* 'aims' to conclude a 30-year contract by the end of this year (but see below).

Differences and Disagreements

Although Russia sees itself as a Eurasian power, it has a European culture, an imperial tradition, a superpower mind-set and a desire to be a 'swing power' between Asia and Europe. These dispositions create cultural and cognitive obstacles to the kind of relationship sought by Russia's Sinophiles, and they routinely cause bemusement and offence in China and elsewhere in Asia. Moreover, Russia's Sinophiles are counterbalanced by those who fear Russia's 'Finlandisation' by its more powerful neighbour—as well as those who simply believe that other potential partners, such as Japan, should not be neglected.

For its part, China looks at Russia through a judiciously pragmatic prism. Although the two countries share a number of positions with respect to the United States, China has no doubt that its relationship with the latter is more wide-ranging and important. It is determined that this will remain a bilateral relationship, with an integrity and dynamic of its own. It has no intention of being manipulated by Russia, which China considers an opportunistic and unreliable partner. (As a case in point, the common stance taken in 2010 on disputed territory—the Kuriles and Senkaku islands respectively—was summarily dropped by Russia in 2012, at a time when it sought to attract Japanese investment).

As it is between Russia and Europe, the energy relationship is both a matter of necessity and a source of tension. China perceives that Russia is more interested in enhancing its own options than becoming a reliable supplier to the Chinese market. Russia abruptly reneged on one pipeline project in connection with the YUKOS affair in 2003. The current gas pricing dispute, stemming from *Gazprom's* insistence that China pay the European price, has lasted six years. When negotiations broke down in 2011, *Gazprom* announced that it would implement a Korean pipeline scheme instead. In the oil sector, Nikolai Tokarev, chairman of *Transneft* has openly boasted of Russia's new 'switch supply' strategy, enabling oil from western Siberian fields to be switched at will from European to Asian (and between Asian) consumers across different branches of the ESPO system. This *modus operandi* makes China resolved to maintain its energy independence.

The arms relationship reflects asymmetrical calculations and needs. Russia wants the business, and Putin needed a strong political gesture to launch his relationship with Xi. China has run into production obstacles with its 5th generation fighter and needs the Su-35 as a stopgap. The relationship also both reflects distrust and breeds it. China desires Russian technological knowledge more than its military equipment (which is sometimes deficient in quality), and it has become proficient at cloning what is supplied. For ten years, Russia had declined to sell China advanced equipment. Putin plainly used his authority to break this moratorium—which is a good indication that he still has it.

It is largely thanks to China that Russia is no longer the only buyer of energy in Central Asia, and it profoundly distrusts China's intentions there. China is now the leading foreign investor in the region's infrastructure development which, in the view of Russian experts, is designed to reorient trade to China and bring about a *de facto* annexation. Russia seeks Japanese and Korean investment in eastern Siberia and the Far East, but not Chinese investment.

China's stance against separatism is consistent; Russia's is rhetorical. The latter opposes separatism on its own territory, in the Balkans, Central Asia and China -- but not in Moldova or the South Caucasus, whereas China will support Georgian territorial integrity on the same principle as it

supports Russian. On the other hand, Russia's opposition to territorial expansion is more consistent than China's. Russia insists that the Second World War territorial settlement cannot be revised; China has claims against the Senkaku (Diaoutyi) islands and, with no apparent basis in international law, claims the South China Sea as part of its territorial waters. For these reasons, there are those in Russia who regard its recognition of the Sino-Soviet border as provisional.

Most significantly for the EU, China does not recognise a Russian 'sphere of privileged interests' in any part of the former USSR. It treats them as independent states and pursues its own menu of interests. In 2012 it concluded an important framework agreement on investment and coal sector modernisation with Ukraine, which is also a well-established supplier of arms to China. (Whether this agreement proceeds, or gets caught in the wheels of Ukrainian bureaucracy remains to be seen).

Conclusion

The conflicting features of the Chinese-Russian relationship—shared interests, asymmetric and conflicting interests, out-and-out rivalry and constant worry—are all growing simultaneously. But both Russia and China have effective leaderships, a clear understanding of their own interests and a determination to protect them, and a good capacity for strategy and the practice of hypercompetition. Employing these tools of statecraft skilfully has kept the relationship in balance. There is no reason why this dynamic should not continue for the present. However, the continued rate of growth of China will soon see its economic power far surpass that of Russia, and this will make it increasingly difficult to maintain this balance in the medium term.

13. The Impact of Chinese Global Activity on EU Security

The Development of China's Global Presence

An assessment of the Chinese impact on the EU's security cannot be limited to Chinese actions in Europe. "Security" can no longer be neatly parcelled into "internal" and "external", and dealt with separately. The extent of globalisation is now such that any significant Chinese action anywhere in the world must be assessed for its significance to the EU. China's activity, by virtue of its global scale and the coherence of China's grand strategy, is changing the global environment in which the EU operates. This in turn demands that the EU develop its capacity for thinking and acting strategically further than it might have considered necessary heretofore; firstly, to understand this process; secondly, to be able to match China's grand strategy. The examples described below are illustrative of this phenomenon.

China's Interest in Polar Regions

The economic and security significance for the EU of the opening of an ice-free northern passage and the significance of the Chinese exploitation of the mineral wealth, and potentially of ice, around the polar ice caps, are issues which need to be considered closely in developing an EU strategy towards China.

In 2012 China defined itself as a "near Arctic State"³¹, the culmination of two decades of increasing interest in polar matters, first at the North Pole and, since 2000, at the South Pole. China has also been seeking to obtain 'permanent observer' status on the Arctic Council,³² a body which has hitherto been dominated by Russia and defined by constant tension between that state and the Western Council Members. A sea change in the approach of the Arctic Council partners to Chinese aspirations was signalled by Norwegian Foreign Minister Espen Barth Eide, who said that "[the] argument for opening up for more observers in the Arctic Council is that they will then be a member of our club.....then the danger of them forming their own club will be smaller"³³.

The first visible signs of Chinese interest were seen in the development of a polar research capability through PANDA, its polar research institute. Interest was also evident in the prospect of global warming leading to the creation of a viable Arctic shipping route, which would reduce transport costs and hence increase the competitiveness of Chinese goods in the markets of Western Europe and the East Coast of the USA. Chinese aspirations have now moved on, driven also by its quest for access to minerals and, more recently, to new sources of fresh water³⁴. These issues will impact upon the EU, economically, politically and in the areas of global warming and food security.

³¹SIPRI Press Release 10 May 2012 reporting on the "Chinese and Nordic Co-operation on Arctic Developments" workshop in Beijing.

³² The Arctic Council consists of eight littoral states including Russia, Canada, the USA and Denmark.

³³Norwegian media reporting an interview by Eide and quoted in the Guardian, 19 March 2013.

³⁴ In part China's shortage of fresh water is driven by its desire for water for industrial purposes. Should China exploit other sources of water on an industrial scale, it is likely to be in order to permit its domestic riverine sources to be diverted to industrial and irrigation purposes.

As with most of their policies, the Chinese have worked with long term goals in mind. These goals include self-sufficiency in terms of control, if not ownership, of things essential to their future, ranging from rare minerals to access to communications routes. Since 2005 they have made rapidly accelerating progress in securing their aim. That these policies are indeed very long term can be observed from the fact that China consistently supported countries such as the UK in wanting freedom of the seas, open straits³⁵ etc. as opposed to those countries - such as the US - which wanted to see greater sovereign control over key sea space. Initially, the Chinese policy was not linked to the development of a blue-water Navy nor reflected any direct national concerns that the West could discern. However, those strategic interests are now clear, as is China's intent to develop a blue-water Navy to protect Chinese interests worldwide

The implications of China's exploiting the Polar sea route will increase the competitiveness of Chinese goods in the European and Atlantic markets and will shorten delivery times, another competitive gain for China. It will reinforce China's reason to develop its military capabilities to protect its commercial interests, including those of its ships using this route³⁶.

In the Polar region, Russia's concerns, in particular about Chinese developments along the Polar sea route, have brought it closer to Norway and its other 'Arctic partners'. The EU too is an Arctic Partner through Denmark,³⁷ and should take advantage of that relationship to improve its relationship with Russia, working more closely with Russia to monitor the impact of developments in the region. Russia too has concerns about its fish stocks, as should the EU, given the increased access to the Polar regions of the North Atlantic which the Chinese will now have.

Industrial scale ice abstraction is a major concern for the short to medium term, whether by China or by any other major state. Research should be conducted in the short term before abstraction becomes more widespread as to those changes which may come about should it be undertaken on a wider scale. This would be a very appropriate activity for the EU to initiate.

As the US 'Deep Water Horizon' disaster illustrated, deep offshore drilling wells have the potential to go catastrophically wrong and when they do so to have environmental impacts over a very wide area. Drilling in the Arctic and the Antarctic combines a hostile climate with severe weather conditions for much of the year, with cutting edge (for which read unproven and perhaps unreliable) technology being used alongside what are currently areas of pristine wilderness. As with the other issues in the area, although these concerns primarily affect the littoral states, they are also of direct concern to their neighbours, in this case the EU. This is particularly a factor when those littoral states are either impoverished or where, such as Greenland, they have very low population bases such that commercial mineral development may make each person within the state individually wealthy beyond the capacity of that society to cope with. This is not a trivial issue.

Finally, any change to the protocols of the Antarctic Treaty should be strenuously resisted and the EU should bring pressure to bear to ensure that water, in the form of ice, is included in the current protocols on the abstraction of minerals. The EU could adopt the role of a global leader in

³⁵ Understandably given its geographical situation another supporter of the UK position was the Soviet Union.

³⁶As China's participation in the anti-piracy patrol off of Somalia demonstrates.

³⁷And through Denmark to Greenland.

monitoring developments in these areas and develop robust policies in order to ensure that these two areas of the globe are managed in an equitable and sustainable manner.

Details of China's activities in Polar regions are given in Annex A, as a demonstration of China's grand strategy. All of the activities have long-term implications for the EU's security; many of them have immediate application. Once again, if these activities are viewed individually, they can all seem innocuous. But, assessed together, their strategic intent becomes clear.

Regional Trade and Energy Routes

Because it sees the world through strategic eyes, China has developed a keen sense of where it needs to have the ability to control sea lines of communication. China's interest in controlling its own close waters has been evident for a long time. Today, China's attention is global, not local. This is bringing it into direct contact with the EU in regions crucial to EU security, such as the Gulf.

Control of the Indian Ocean is perceived by the Chinese as being vital to their strategic interests, in particular in so far as securing shipping routes for export and for energy imports. "Control" is not achieved by any one means, but by a strategic combination of factors. Developing a blue-water navy is one such tool. Investing in strategic infrastructure is another. In order to increase their presence and influence in the region the Chinese have been building a number of large commercial ports: Gwadar in Pakistan, close to the Gulf; Hambatota in Sri Lanka; Chittagong in Bangladesh; Sitwe in Burma. Security analysts have called this dotting of ports in strategic points all around the Indian Ocean China's "string of pearls", which could, in time, give China maritime hegemony in a region which is important to Europe's energy security and trade routes in general, particularly in the Gulf and close to the straits of Hormuz.

Latin America

China's activities in Africa have been given significant publicity over the past decade. In comparison, China's involvement in Latin America has been scrutinised much less. Latin America provides an excellent example of China's expansion onto the world stage in a way that has a direct impact on the EU. Firstly, Chinese penetration of Latin America impacts significantly on both the prosperity and security of the EU. Secondly, the scale of Chinese engagement with and investment in Latin America demonstrates how China is able to change the environment in which EU and other Western actors have to compete. Thirdly, Chinese stratagems for gaining influence and control in Latin America are now being replicated in Chinese dealings with Europe.

Focusing on the impact of China's engagement strategy in Latin America allows us to demonstrate how China has moved rapidly and consistently in a manner so as to usurp a US hegemony in the region which, by the mid-1950s, was almost total (following the US takeover of the British assets in Argentina and Chile -particularly the minerals, railways and meat packing- as a result of lend lease payments in World War II). China's competitor in the region now and in the future will not be the USA, but the EU, both for strategic minerals, markets and, of course, political influence. That these

moves have occurred largely unnoticed by the West has been a 'bonus' and will permit China to replicate this strategy elsewhere.

Annex B gives details of China's expanding engagement in the region. It is important to relate these details to our overall analysis of China's grand strategy and to note the extent to which the initiatives interlock and reinforce one another. A good example is the engagement with Argentina and the Chinese action regarding Antarctica outlined above and given in detail in Annexe A. The custom of addressing China's actions in different countries of the world individually can easily lead to the significance of the close links between them being overlooked and the overall strategy being misinterpreted or remaining invisible.

For this reason we have given at Annexe B an outline of China's activities across the region so that the scale of the effort can be appreciated. It is this capacity for acting on a large scale which gives China its ability to change the global environment in its favour. Another reason for examining China's actions in Latin America, as in Africa, is that the tactics first employed in dealing with developing countries are now being seen used against the EU and Member States.

14. The EU's Strategic Response

The EU's record to date in dealing with China has had only limited results³⁸. The policy of "Unconditional Engagement", which gives China access to all the economic and other benefits of co-operation with the EU, has done little to influence China's domestic and foreign policy in a way which reflects European values. The EU allows China to throw many more obstacles in the way of European countries wanting access to the Chinese market than Chinese companies face in the EU. China regularly opposes the EU on issues of global interest, and China is guilty of "Splittism"- tactics of "divide and rule", dealing with regional groupings of Member States in defiance of Brussels' wishes. The Chinese know their own strengths, and have understood the EU's weaknesses well. The EU is strong; but it has not turned its strength into power. China is now exploiting those weaknesses, and the EU's failure to react effectively only increases China's contempt for the organisation.

The fact is that most of the EU's policies, mechanisms and procedures are designed on the basis of the underlying philosophy that inspired the founders of the Union – that is, of nations voluntarily signing up to a common code of conduct based on shared values and standards, subordinating individual interests to the common good. This has been the basis for the EU's approach to its relationship with China, as it has been for the rest of the developing world, from the time when it saw China as a "developing country". This attitude has motivated the policies of offering China unconditional access to the advantages of collaboration, and of not applying reciprocity in trade dealings with China on the grounds that this would encourage China aspire to adopt European values and standards. This attitude is now totally and completely inappropriate. It can be argued that the failure to recognise this fact has been the single greatest cause of damage to the development of a good working relationship with China.

To deal successfully with China, the EU needs to understand China in its own terms, and to acknowledge China's cultural differences and ambitions. This means helping China to find its place in the evolving global order without it being to the EU's or the West's detriment, and without expecting the Chinese to become like us. We can learn things from China whilst maintaining our own values and upholding our own interests. But to do all this successfully will require us to know what our values are and to articulate them, to understand and acknowledge our own strengths and weaknesses as well as China's, and to be prepared to use all forms of power in pursuit of our goal. *"Know your enemy and know yourself"* said the Chinese strategist Sun Tzu in *"The Art of War"*, published in the Fifth Century BCE, *"and you need not fear the result of a hundred battles."*

To improve its working relations with China and to ensure the EU's internal security, it will not be sufficient for the EU to limit itself to internal measures, be they reactive or proactive. To impact on the EU's internal security, China does not have to operate inside the EU but only on the networks that affect the EU. To take a very simple example with an immediate and obvious "food security" effect on the EU's food chain: China's purchase of large quantities of South American corn significantly raises the price of beef in Europe, as it deprives Argentina of the cheap imported feedstuffs for its beef herds, for which the EU is its main market.

³⁸ECFR Report: A Power Audit of EU-China Relations

Nor can the EU hope to succeed in developing a secure relationship with China if it only considers tactical, short term actions. China thinks and acts not only strategically, but it does *grand* strategy, i.e. very long-term and large scale, with global impact. China is not an “emerging power”. China is a major global power. It has reached that position with historically unprecedented speed, and it is continuing to evolve and grow. It is no longer acceptable for the EU to say that it “cannot do strategy” as it is equally unacceptable for Member States to say that “they cannot think or act long-term because of their 4/5 year electoral cycle”. The EU’s limitations are acknowledged, and such constitutional reasons are real issues, true, but they are no excuse. The EU and its Member States need to work to find institutional mechanisms to overcome these limitations and recreate their capacity to do strategy and grand strategy.

Developing a capability and capacity for strategic thinking and acting does not, at least initially, require a formal structure. Indeed to confuse a real ability to do strategy with formal mechanisms claiming this function is an all-too-common error. The basic components needed for strategic thinking are: clever, educated people; a common understanding and purpose; time and space to think and debate, and; the ability to experiment and learn (from mistakes). How to turn the results of that thinking into action is one of the first tasks of the thinking. Formal channels are valuable here, but again, they are not essential. In essence, we are talking about growing a brain and nervous system for the EU, fully understanding that it may be impossible to do so formally because of internal political tensions and lack of resolve on the part of the Member States.

This process, then, needs to be started ad hoc, with existing resources and within existing structures, perhaps within the European External Action Service (EEAS). All the essential components listed above are potentially available, even if the time and space requirement will pose a challenge to find/create. Some of the thinking can be outsourced, as is already done with ECRAN. Identifying who will take the lead in forming this network and setting it to work is all that needs to be done to start the process. This may seem a bureaucratically formidable task, but it is in no way impossible, or beyond the capabilities of the current EEAS team.

The task of this (informal) strategy group is not just to think about how to deal with China, with other Strategic Partners or indeed with any other third country. It is also to address how to find ways to improve the coherence of the EU and the communication between Member States. It needs to find ways to improve the ability of the EU to evolve more effectively so that it can remain more fit-for-purpose in today’s rapidly changing global environment, something China is proving very adept at doing, at least for now. An EU strategy towards China, therefore, needs to draw on the strengths of the Member States whilst supporting and protecting those smaller Member States which do not have the resources to develop their own robust strategies.

Challenging China

An important message for the EU and its Member States alike is: if you take on China, make sure that you understand what you are doing and that you are prepared to fight and win. China respects power, unity and a strategic sense of purpose in its partners, not least because of its own bitter historic past. However, the economic crisis has done a great deal of damage to the EU and its

Member States' image and credibility around the world. It has also amplified a problem evident in the recent past – the growing loss of solidarity amongst EU Member States towards each other, combined with a reassertion of Member States' authority over EU institutions in Brussels, reducing the EU's ability to act quickly and decisively in a world which is changing ever faster. This may not have mattered too much in the past, but now - with such a powerful, strategic actor as China in play - the game is more important and more challenging than it used to be.

It has become increasingly difficult for the EU and its Member States to reach decisions, especially when it comes to China, because of the multiple internal actors involved and because everyone wants to have a say because the Member States have competing interests. The institutional division of responsibilities between the EEAS and the European Commission is working adequately well, but it has not simplified matters. More problematical has been the tendency for parts of the European Commission to take decisions in their own areas of technical competence without adequately taking into account the impact that this may have on the overall EU-China relationship. This has been graphically evident in the past year in the fields of climate change and trade³⁹,

In all of the above cases, the EU and its Member States must take greater care not to let short- or medium-term interests, or single policy areas, jeopardise what should be its *objectif prioritaire* as a strategic actor: that is, the building of a stable, reliable partnership with China, and the safeguarding of its unified approach.

If a decision is taken to create a major dispute with China, a thorough foreign policy analysis must be undertaken beforehand to ascertain the likely impact and to identify and assess how to manage the various scenarios that might result. Once such an action is launched against a determined, strategic player like China, it must be carried through to the end. For China will use the dispute as an opportunity to erode the remaining strengths of the EU. Trade is currently the only form of power that the EU can wield which China really fears, because China knows that it can do its economy serious damage and lead to social instability amongst its own population. That is why China will use all means to win in any dispute, and will also use the occasion to weaken the EU in the longer-term.

The Potential for Collaboration with NATO

Although it may seem at first glance unlikely, there is a serious opportunity for the EEAS to draw on NATO's experience and expertise to enhance the EU's strategic capability. NATO is generally thought of as a military organisation, and its current preoccupation with Afghanistan reinforces this

³⁹ The aviation ETS dispute has seen a remarkable array of countries line up in opposition to the EU, including the unwelcome alliance between China and the United States against the EU for the first time. There has also been a steady rise in EU-China trade disputes, culminating in EU provisional measures to be imposed on Chinese solar panels, and the likelihood of a subsidies investigation being opened on Chinese telecommunications giants Huawei and ZTE in June 2013. Both these trade disputes strike at the heart of China's economic ambitions and will lead to significant job losses, in particular for the Chinese solar panel industry.

perception. But, above all else, NATO's main contribution to European security throughout the decades has been through its mechanisms for dialogue and confidence-building.

NATO's various partnership programmes create space and provide what are often the only opportunities some nations have to meet and talk in discreet surroundings with other nations with which they have problems, or do not wish to be seen conversing formally. Moreover, the Summit and Ministerial conferences which NATO holds allow third party countries with a benign interest to exert gentle pressure to bring together informally conflicting parties which are resisting dialogue.

The Asia-Pacific Region is sorely lacking in Confidence-building Mechanisms and would benefit greatly from the kind of dialogue structures and processes which NATO has established for Eastern Europe and former Soviet countries over the past two decades. Such an asset would allow dialogue between regional countries both with China and about China, and would allow discussion between regional actors and the rest of the world.

NATO is already engaged in dialogue with some Asia-Pacific countries, but that dialogue is constrained because of the perception of NATO as military. The EU is under no such handicap, and could establish a formal "partnership" process which would bring with it just such dialogue and confidence-building mechanisms. This would be of immense value to regional security and harmony, as well as greatly contributing to the reputation of the EU as a global strategic actor. There can be little doubt that HQ NATO would provide any intellectual support necessary, should that be requested.

The Arms Embargo on China

The imposition of the Arms Embargo was in response to the Tiananmen Square crackdown in 1989. It still represents an emotional response to China's poor human rights record, especially for the European Parliament, not least because, having neglected the development of a capability to make and implement strategy, such an embargo is one of the very few political tools available to the EU.

Sanctions and embargoes, meanwhile, have become a disputed issue within the EU. A recent analysis⁴⁰ of the EU's use of sanctions and embargoes generally shows that it is very difficult to establish if these are worthwhile. The argument centres on whether these policy tools achieve the aims for which they were created or whether, especially in the case of China, they are ineffectual, unnecessary, or even counter-productive.

Whilst maintaining the Embargo might be justified as a symbolic act expressing EU continued displeasure, it would be worthwhile considering whether its lifting would contribute to improving the EU's relationship with China or not. In fact, on closer inspection, the issue is more complex than at first sight it appears. Indeed, it is only possible to assess the impact of sanctions in a strategic framework, where an understanding of the bigger picture can change the assessment completely.

⁴⁰ See the European Council on Foreign Relations' report "Shooting in the Dark? EU Sanctions Policies", 9 Jan 2013

A strategic approach would ask the question: Does the embargo have a greater impact on China, or on the EU itself? In response to the question: have sanctions actually stopped China acquiring anything it really wanted, the answer seems to be “No”. The Embargo is not legally binding on EU Member States. UK Searchwater radars and the French AS-365N Dauphin-2 helicopters have been exported to China. Swedish companies specialising in Computer Aided Design are selling China the knowledge and tools to build weapons. Russia and Israel are still doing business with China. A dispassionate analysis would conclude that the Embargo is a political illusion rather than a military reality.

In addition to the emotional reason noted above (which is by no means an insignificant reason in political terms), the two other reasons to maintain the Embargo seem to be: the Chinese want it lifted, so it must be hurting; and, the US is very keen to for the EU to maintain the Embargo. An EU strategic approach would have to consider, therefore, why the US was so keen and if acceding to the US wish actually served EU interests.

The US policy is designed to maintain the US’ technological advancement and industrial competitiveness over China and everyone else. If the EU Embargo contributes to this in only a small way, the US will seek to persuade the EU to maintain the Embargo. But the EU must also take into consideration that the US policy of maintaining industrial and technological advantage also applies to the EU, which in this instance is a competitor to the US. As with many things, this issue appears to be a matter of judgement. In supporting US strategy towards China, the EU might in this instance be acting against its own interests, which may be better served by removing this barrier to trade.

The Embargo cannot even have much useful symbolic effect if the Chinese population are not aware of it or affected by it, as seems to be the case. Taking refuge in a face-saving illusion does not seem to be a sensible way to convince anyone that the EU or its European Parliament are serious political players. Is it so important to the EU leadership to curry favour with the US by maintaining the Embargo in US, rather than EU, interests? It might well be so. Unfortunately, unless the EU develops its capability for strategic thinking it will not be able to answer these questions.

How much more satisfactory it would be if the EU could develop an understanding of what forms of power it could generate as tools of foreign policy and strategy and devise mechanisms to implement those powers. How much more satisfactory would it be if the EU could articulate its own strategy towards China and stand up for its Member States’ interests with their full backing in dispute with its allies as well as with its opponents. If China wants the Embargo lifted, then this has a strategic value and a price can be extracted for the lifting. It might be unrealistic to expect that price to be very high, but that is where the skill of the negotiator would come in. This is the essence of the strategic approach. The issue of the Embargo on Arms to China is an example of the confusion of thought that accompanies the absence of an internal capability to think and act strategically.

15. A Summary of Policy Recommendations

EU Institutions

5. Create an informal strategy group within the EEAS, drawing on existing resources of talent. Develop this as a basis for a formal group.
6. Ensure that any actions to be taken by European Commission services which could have wide ramifications go through a foreign policy “impact assessment”.
7. Engage EEAS and Commission research instruments to undertake essential research, including with Member States, on all key issues relating to EU security and China, including issues such as Hypercompetition
8. Create a Forum of Asia-Pacific States, on the lines of NATO’s instruments for dialogue and cooperation, to discuss issues of regional security and cooperation. This can also be started informally if necessary.

Chinese Relations with Member States

5. Monitor Chinese engagement with groups of Member States and prevent any such regional groups from forming secretariats or permanent staffs to support the activities of such groups.
6. Assess the needs in particular of the smaller EU Member States concerning their relations with China and try to find solutions for them at the EU level.
7. Ask Member States to inform the EEAS and each other of the ongoing contacts they are having with China, leading to coordination of positions when necessary.
8. Monitor, and disseminate details of, recent Chinese immigrant communities in Member States.

Resources

Energy

9. Energy Efficiency: One way to reduce European supply dependency would be to enhance energy efficiency. Boosting investment in energy efficiency research would be a worthwhile way to reduce supply dependence.
10. New Renewables: Europe needs to change its approach to renewables. The 2007 climate change strategy and renewables policy was a sensible response in a context of rising - and what were thought to be permanently high – prices for fossil fuels. However, with the advent of the shale revolution, the growth in fossil fuel supplies is going to cut fossil fuel prices. It will be impossible to sustain today’s costly renewables technologies. Given the EU’s weak resource profile, we do need renewables. But we need to develop second and third generation technology which is much cheaper and which must be “free-standing” (i.e. which does not require back up fossil fuel power generation). This analysis speaks to the

need to develop a major European R&D programme for renewables with water as basis rather than wind.

11. Shale Development: It is clear from the French, British, German and Polish geological reports that the European Union has significant quantities of shale gas which can be exploited. Developing these resources would help to reduce European supply dependency.
12. Offshore Resources in the Eastern Mediterranean: For similar supply security reasons, the European Union should support development in this region. This will require the provision of hard security, i.e. a significant degree of classic military power.
13. Methane Hydrates Research: At a conservative estimate, there is over 3000tcm of Methane Hydrates available worldwide (total annual global gas consumption is just above 3tcm). There are considerable resources in European waters. As yet, research has not produced effective commercial processes. However, methane hydrates could be a source of significant energy resources in the coming years. This is another major candidate for EU research funding.
14. Natural Gas Vehicles: The greatest supply threat to Europe is in respect of oil. Our oil resources are dependent on (a) the stability of Russia and (b) the willingness of the United States to police the gulf. The US, because of the shale revolution, is investing in natural gas vehicle technology. This is an area where Europe should also be engaged, principally to reduce supply dependence.
15. Build an Energy/Resource Relationship with Japan: The only other major economic entity with similar resource problems to those of the European Union is Japan. Many of the research projects discussed above are also of interest to resource-strapped Japan. There is an identity of interest worth exploiting here

Minerals

16. Supply Substitution: In relation to rare earths and specialized minerals, the European Union should seek to identify those natural resources that raise the most significant supply security issues and design a substitution research programme around them. The aim would be to develop substitutes and alternatives, thereby undermining any potential Chinese monopoly, while developing our research base and creating new industries.

Finance and Investment

4. Establish a centre within the EEAS to work with Member States to monitor and analyse Chinese investments, both in Member States and globally. Resource it to disseminate information and to engage in education on this topic
5. Improve legislation to close loopholes which allow China to operate unlicensed and unregulated financial institutions, such as for credit rating.
6. Press the Chinese authorities to publish data about their investments in Member States.
7. Establish a single system and a common accounting process for Member States to record foreign holders of public debt

Infrastructure

4. Initiate a study with Member States to establish a common minimum definition of: what are the principal elements of national security; and, what constitutes for each Member State critical national infrastructure and critical areas of their economy and society.
5. Work with Member States to do risk assessments for their critical national infrastructure and critical areas of their economy and society.
6. Publish assessed minimum standards (Red Lines) for ensuring that Member States maintain control of their critical infrastructure and economic assets, e.g. transport; ports, airports, roads, railways: essential distribution and supply networks: energy generation and supply: utilities; water, sewage: banking and financial structures: telecommunications: IT services, including cloud computing.
7. Monitor especially Chinese investment in and acquisition of Member States infrastructure, supply chains and critical areas of their economy. Publish and disseminate regularly details of this investment. Improve legislation to oblige Member States to gather and share within the EU comprehensive information on these investments.
8. Establish a system for vetting direct foreign investments into critical infrastructure and key areas of the Member States' economies.
9. Ensure security considerations are taken into account in the forthcoming EU-China investment agreement.

Trade

4. Press the Chinese authorities to be transparent about the ownership, composition and financing of all major corporations wishing to work in the EU, as a condition for a licence to operate.
5. Establish a process of reciprocity to compel China to open its markets to EU participation to the same extent as the EU is open to Chinese companies.
6. Work with Member States to improve the level of understanding, in governmental departments and in the corporate world, of Chinese policy, strategy and tactics.
7. Work with Member States to improve the consistency of dealings with China, e.g. on contracts, financing and investments.

Defence

3. Improve research into Chinese military developments, capabilities and capacities, and into Chinese defence exports and defence diplomacy (e.g. exercises with third party countries)
4. Sponsor seminars and workshops with Chinese defence experts to improve mutual understanding and confidence-building.

Law Enforcement

8. Strengthen Europol's capacity to support Member States' monitoring of internet sites advertising counterfeit goods and other products of Chinese organised crime.
9. Enable Europol to negotiate an agreement with China to track down and bring to justice those ringleaders of organised crime in Europe who are based in China.
10. Reinforce the European Cybercrime Centre to raise awareness and to support investigations in the Member States.
11. Increase the number of interpreters for Chinese languages and enable their sharing across the EU. Establish a system to make competent, trusted interpreters available at relevant ports, airports and other key points.
12. Encourage Member States to improve intelligence gathering on Chinese crime and to share the results
13. Improve cooperation with the Chinese authorities, including the signing of formal agreements and engaging in joint workshops to increase mutual trust and encourage the exchange of intelligence.
14. Improve European legislation on illegal drugs and counterfeit goods to enable more effective enforcement and prevent evasion of the laws.

Cyber

7. Establish an EU equivalent of the NATO centre of excellence in cyber. Resource it to monitor cyber incidents in the Member States and in other countries and to establish EU standards and a code of practice.
8. Improve legislation to make reporting of cyber incidents obligatory by Member States, and to oblige Member States to do risk assessments of the vulnerabilities of critical national infrastructure and critical areas of their economies and societies.
9. Modify the Framework R&D programme to prioritise cyber⁴¹.
 - a. Sponsor a research process drawing on existing EU staff and using appropriate Institutes within the Member States. Create a body of people who can combine research, active work to combat the problem, and educating a new generation of "cyber warriors". Only an institution which can combine these three functions will be able to keep abreast of developments in this fast-moving sphere. This group will be able to prepare both a counter-strategy and counter-tactics. Counter-tactics may

⁴¹ Note that much of the advanced capability and capacity is likely to be not in state institutions but in private companies, often small ones, and in the abilities of many individuals who (unlike in China) have not to date been harnessed to work for state ends. The US FBI's experience of recruiting criminal hackers, who then continued their criminal activity in their government roles, indicates how much more difficult this type of thing can be in our societies, where the consequences of betraying one's employer are not so dire as they might be in China. This will require new, imaginative and flexible models of collaboration and engagement to be devised so that these resources can be drawn into the above programmes.

include developing the capability for retaliation in kind. A counter-strategy is likely to be asymmetrical.

- b. Sponsor work on defensive measures on a large scale, including: improving awareness; improving passive and active security measures in official and private commercial institutions; educating young people in defensive thinking and more careful, ethical use of computers and mobile phones (as is currently being done in the USA and in some alert Member States, such as Estonia).
10. Disseminate information about the nature and scale of the cyber problem and about the underpinning Chinese philosophy and policy. Bear in mind that other states and non-state actors already emulate the Chinese approach.
11. One particularly appropriate response could be for the EU to create a new, alternative web/webs. When the current web was created, it took all the existing world-wide resources to do so. But now we have the hardware and software to create webs which are private, centrally controlled, equipped with Trusted Network Interface Units to restrict access. This would be a separate EU network dedicated to specific purposes, more difficult to interfere with than the current web, which it would supplement, rather than replace. It would, moreover, give a much-needed boost to EU hardware and software producers as it would be essential for its security to rely on EU manufacture.
12. Publish *Red Lines* for the guidance of Member States. These could include advice to prevent Chinese companies from dominating the hardware and software market and the R&D process, or from gaining access to national telecommunications systems. Chinese hardware prices may be only 10% of their EU counterparts', but will the saving made by buying Chinese be worth the 100% loss of control of electronic infrastructure or information security?
13. Co-ordinate between Member States, with other interested countries, and with major international corporations to agree, to the extent possible, a common approach to tackling cybercrime.

Education

4. Encourage Member States' reporting of Chinese educational initiatives, funding and conditions demanded, e.g. for establishing Confucius Institutes and language courses.
5. Monitor Chinese take-up of courses in Member States and publish details.
6. Sponsor the study and monitoring of Chinese global commercial, political and social activity. Generate a "China Studies" community amongst Member States.

ANNEX A

China's Strategy towards Polar Regions

The Polar Sea Route

In the last three years, the Polar sea route has become a practical reality.⁴² It reduces the distance between Shanghai and Northern Europe by 4,000 miles. This route saves a bulk carrier between twelve and seventeen days, depending on the ports of departure and arrival. This means approximately £250,000 in fuel and other operating costs⁴³. The immediate effect is reduced transit costs for goods in those summer months when the route is open. The more cost effective it is demonstrated to be, the more the pressure will grow to keep the route open for longer and to turn it into an all year round transit route.

For China, the opening of this route reduces its dependence on the crowded and potentially dangerous⁴⁴ Malacca Straits, through which much of its imports⁴⁵ as well as exports flow. It provides it with improved or perhaps safer access not only to those sources of oil production which it has currently,⁴⁶ but also to other markets, such as the Rotterdam spot market. The growing Chinese use of the Polar route will impact on the EU, therefore, not only in terms of sales and competition with domestic suppliers of goods, but also in the energy market and potentially in food markets.

Mineral Resources in the Polar Region

The US Geological Survey (USGS) has estimated that some 30% of undiscovered natural gas reserves lie within the Arctic Circle. This is a factor which has clearly influenced Russia in its current claims to the Lomonosov Ridge⁴⁷. In addition, the Arctic is believed to have vast deposits of oil, coal, rare earths and uranium, all of which are attractive to China which is rapidly securing a monopoly of the market in access to some key minerals⁴⁸.

As with Antarctica, China's interest in the Polar region has been very long term and will continue to be so. It would appear that, for relatively modest investments both commercially and politically, China can secure long term dividends. China's focus on the region has passed relatively unnoticed until recently. This 'quiet approach' is now changing, firstly with the opening of the Polar sea route and now with proposals for direct investment in the region and the proposed opening of large commercial-scale mining projects.

⁴² In 2010 there were no transits, but in 2012 there were forty six.

⁴³ Ironically it also greatly reduces CO2 emissions for the vessels concerned.

⁴⁴ Because of the threat of piracy.

⁴⁵ Currently 80%.

⁴⁶ For example those in the Middle East, particularly the Gulf and for which both china and Japan are major customers.

⁴⁷ In the current round of the UN Law of the Sea Conference (UNLOSC). Russia has cited the UK's position on Rockall (as part of the UK's continental shelf) in support of its application.

⁴⁸ China has currently secured up to 90% of the market in exploitable rare earths.

An example of this investment is China's proposal⁴⁹ to mine fifteen million tonnes of iron ore for export to China from a site North-East of Nuuk, the capital of Greenland. As part of any agreement with the parliament of Greenland⁵⁰ this £1.5 Billion project⁵¹ would require the Chinese to locate a three thousand strong team of workers in a country with a total population of only fifty-seven thousand. This pattern of China's exporting its population is seen elsewhere.

Another small Polar littoral state, Iceland, has so far resisted Chinese blandishments which have been directed at the development of tourist resorts on the island and deep sea ports. Chinese interest, however, continues unabated. The attraction of a year round base in the North Atlantic from which to develop its mineral exploitation, and perhaps first level processing, is obvious. At present, for the Icelanders, environmental concerns are outweighing commercial advantage. But any further serious turmoil in the island's economy might precipitate a rapid alteration in the attitude of the local population. As it is, the Chinese are disposed to wait and to watch the situation develop⁵².

China's Developing interest in the South Pole

China's Polar and Antarctic Research Agency, 'PANDA' was established as an Arctic exploration unit but, since 2000, its focus has shifted increasingly to Antarctica. Originally with a base in Chile and latterly in Argentina, PANDA has declared its scientific interests to be primarily in the area of geophysics. Much of the work carried out has been in or close to the UK areas of interest in the region. In part this has been because they have used the British Antarctic Survey (BAS), based in the Falkland Islands, to provide transport to and from their areas of research⁵³. Commercial mineral extraction is unlikely to be possible in Antarctica in the short to medium term but, if one is working to a fifty to seventy-five year timetable⁵⁴, as China is, then Antarctica represents the world's largest single untapped source of hydrocarbon fossil fuels and possibly also of iron ore. Current Chinese interest in the area and its burgeoning relationship with (and in some cases financial and political support for) Antarctic littoral states such as Argentina, South Africa and even Australia, represent a modest investment for possible future access to these resources. China is also showing interest in the untapped fishery resources of the region.

⁴⁹ Technically the proposal has been made by the UK based London Mining plc.

⁵⁰ Greenland is a self-governing part of Denmark which amongst other things matters retains responsibility for its Defence.

⁵¹ This is equivalent to an investment of over £26,000 for every member of Greenland's population.

⁵² Their long-term interest in Iceland can perhaps best be benchmarked by their investment of £160 million in the construction of a new Chinese Embassy in Reykjavik.

⁵³ BAS although funded by the UK Government have been required to achieve as much 'cost retrieval' as possible by commercially chartering out their assets such as aircraft and research vessels. The Chinese have taken advantage of this opportunity and 'competition' with other providers to use BAS.

⁵⁴ As the Chinese 'String of Pearls' theory might suggest. For a discussion as to whether Western concerns as to this policy are valid are debated in an article by Alex Vines "Mesmerised by Chinese String of Pearls Theory", *The World Today*, Vol. 68, No. 2/3.

Resources on Land

Antarctica is the location of the largest proven reserves of coal⁵⁵ and a range of other mineral resources, such as iron ore, sealed in places by a sheet of ice over 3000 metres thick. The exploitation of coal at those depths through the covering sheet of ice⁵⁶ is not currently economic, but may be so in the not too distant future, in particular after the protocol to the current Antarctic Treaty⁵⁷ (which bans the exploitation of all of all mineral resources) terminates in 2048. It is worth remembering that, before the deep oil fields were exploited in the Northern North Sea, it was recognised that the technical capabilities required to exploit these mineral resources were not available, nor was there sufficient demand to make the investment required to develop the technology worthwhile. But by the 1970s that economic situation had changed. This is likely to be true for Antarctica too.

Coal is now known to exist in many areas across the continent, but particularly in the Trans-Antarctic Mountains and in the Shackleton Range. Much of the coal discovered to date has been low grade shale, a further deterrent to commercial exploitation at the moment.

The iron ore is primarily located in the Prince Charles Mountains⁵⁸, an area under Australian control. Australia is a country in which China has already invested heavily in order to secure access to mineral resources. Although there has been limited identification of other Antarctic onshore mineral resources to date, the increasing technical sophistication of geophysical research may yet identify commercially exploitable reserves.

Resources on the Seabed

China has obtained and studied carefully all available earlier work, such as the Shackleton report on the Falkland Islands in the early 1970s, which cited UK research work into the presence of large deposits of manganese nodules on the South American coastal shelf around the Falkland Islands and of the presence of large oil and gas reserves under the seabed. Within Antarctica itself, the principal oil and gas reserves lie in the Ross Sea and are protected until 2048 by the Protocol on mineral extraction.⁵⁹

Ice and Glacier Melt as a Source of Fresh Water

The Antarctic contains some 70% of the world's fresh water locked up in the ice sheets which cover the continent. The use of ice and meltwater as a large scale, commercial source of fresh water is already well exploited, in particular by Japan and the State of California, which secures no less than 15% of its fresh water from cut ice. The Japanese methodology, which has now been employed for

⁵⁵Trewby, Mary, ed. (September 2002). *Antarctica: An Encyclopedia from Abbott Ice Shelf to Zooplankton*. Firefly Books. ISBN 1-55297-590-8.

⁵⁶ Dependent upon the season only 1 – 5 % of Antarctica is exposed from under the ice sheet.

⁵⁷ [Protocol on Environmental Protection to the Antarctic Treaty](#).

⁵⁸ These iron ore deposits were discovered and mapped by a series of [Australian National Antarctic Research \(ANAR\) expeditions](#) in the period 1954-61.

⁵⁹ Ibid.

some twenty years, has proved to be particularly cost effective and they have secured contracts with New Zealand to fill water tankers with glacier melt water in the fjords of New Zealand's South Island for shipment direct to Japan.

China is facing in the short to medium term chronic water shortages caused in part by population growth, but principally by the increased need for water for industry and, to a lesser extent, agriculture. The use of cut ice from either the Polar ice cap, Antarctica or the North American or Eurasian continent has been proven to be a viable method which could be utilised to meet that shortfall. It would also be a cheaper and more practicable solution than desalination, given the vast scale at which China would require to operate. It remains to be seen whether the protocol to the Antarctic treaty⁶⁰ could be invoked if one of the Antarctic states, such as Chile or Argentina, were to permit the abstraction of ice for peaceful purposes. What is clear is that this was not considered as an option at the time when the treaty was drafted.

While not yet an issues in the global arena, Canada in particular is exercised about the ownership and abstraction of ice and this is a political issue in some parts of that state. Clearly their concerns, at least in the short term, are the effects of massive amounts of ice removal from their ice sheets to feed the growing market in their neighbours to the South.

While it is not likely that China will embark in the short term upon such a radical step as to contract for large quantities of one or more ice sheets, it remains a possibility that it may wish to do so in the not too distant future and in such a manner, given its large financial and commercial resources, as to encourage a state with such a 'resource' to permit extraction to go ahead.

The Effects of Increased Commercial Activity and Ice Abstraction on Global Warming

There are already concerns about the commercial exploitation of Antarctica and widespread concern about Polar melt and the impact of man's activities on the Polar ice-cap. Commercial shipping and mineral exploitation in the Polar region in the short to medium term will exacerbate those concerns, even if not in the states involved. Chinese activities in the Polar regions will have an impact upon the territories of EU Member States⁶¹ and should be of direct concern to the EEAS⁶².

The reduction in the size of the ice sheets and the exposure of land masses has already been proven to accelerate the effects of global warming by reducing the amounts of solar reflectivity. Pollution of the pristine ice surface by contaminants such as oil and sludge has also been found to have this affect and to increase the rate of ice melt of the ice so affected. Large scale ice abstraction, therefore, whether by China or any other state, will directly affect global warming and lead to a more rapid diminution of the Polar ice caps and hence rising sea levels. That is an issue for international concern, not simply that of the states concerned, nor even of those littoral and perhaps impoverished states in the Southern hemisphere, which may wish to turn a 'blind eye' to

⁶⁰ Ibid.

⁶¹ In particular Denmark, through its responsibilities for Greenland, Iceland and Norway in particular due to the proximity of Svalbard to the Polar ice cap.

⁶² There will also be direct impacts upon Russia and Canada both of whom form part of the wider 'European' security architecture through their membership of the Organisation for Security and co-operation in Europe (OSCE).

the activities of others in return for financial subsidy. Ice abstraction other than for purely local and traditional purposes, such as by the small native populations, should be subject to worldwide regulation and its impact on the global environment subjected to more detailed scrutiny and scientific research.

ANNEX B

China and Latin America

China's rapid urbanisation process means less arable land cultivated for food production, and more people to feed. The "red line" for food security is at 120 million hectares of arable land (minimum amount of land needed to feed the Chinese population), and some experts believe this has been crossed already. (Cardenal and Araújo, p.317, note 32).

Since 2007, China's demand is the largest in the world for tin, zinc (Bolivia), copper (Chile and Peru), soya beans (Argentina, Brazil and Paraguay), oil (Venezuela and Ecuador). Chinese demand sets the world price for these commodities. Volume of trade between both went up 50% in one year, reaching in 2003 US\$ 26.806 million.

Since joining the WTO, China's demand for food supplies is more open than those of the USA and Europe. By 2010, barriers to the import of food products dropped more than 70% for cheese and butter, 69% for beef, 55% for milk, and 44% for poultry. Import quotas for maize and wheat have gone down 60% and 32% respectively.

Sales by Brazil, Argentina, Peru and Chile of copper, iron ore and soya, needed for China's food industry, helped boost Latin American sales to China 45 per cent in 2005, to \$21.7bn. Overall, bilateral trade has more than quadrupled in 2000-2005. In 2004, for the first time, South America topped Hong Kong and the rest of Asia as the top destination for Chinese foreign investment

But Chinese companies face difficulties in adapting to localities and challenges very different from home. Throughout South America, Chinese managers have developed a reputation for insularity by cordoning off Chinese workers from their local counterparts, and by failing to work with local businesses and services. Unaccustomed to facing recalcitrant unions or angry shareholders at home, the firms have also reacted slowly to demands from local workers. This has caused most problems in Peru.

Furthermore, Latin American industry is not able to face a competitive threat from China, and China is focusing on extractive industries that create fewer jobs and add less value. Critics also point out that much of China's foreign investment in Latin America is funnelled directly into offshore tax havens in the Cayman Islands and Bermuda.

China and Argentina

In Argentina, the Chinese see a potential export market but more importantly in the short term they see a major food exporter and in the long term a state with almost unlimited access to fresh water and coal due to its 'possession' of a large part of the Antarctic continent. Added to that the coastal littoral of Argentina is a potential source of oil and gas while the seabed on the coastal shelf projecting out to the Falkland islands is known to be rich in manganese nodules and potentially other minerals.

In the short term, the underlying financial weaknesses within the Argentine economy have permitted China to quietly secure a dominant economic position thus further undermining the US 'Monroe Doctrine' and to be in a position to dominate and exploit Argentina's potentially massive assets in the longer term.

Beijing has invested heavily in energy in Brazil and Argentina (though CNOOC's purchase, with its Argentine partner Bidas, of a 60 per cent stake in Pan American Energy from BP is reportedly veering towards the rocks),

In 1972 the first diplomatic links established. 1977 saw the first trade agreement. In 1978 a maritime transport, scientific and technological cooperation agreement was signed.

By 2005, there were 60,000 Chinese living in Argentina, mostly arrived during the 1990s, from Fujian province (SE China). In 2011 this had risen to 75,000.

The Sino-Argentine trade association listed 5,000 Chinese supermarkets in 2005; in 2012 there were 8,900: they control 30% of the supermarket sector. Twelve Chinese families control the whole sector. They are already operating in the same way in Bolivia, Chile and Ecuador.

Adding Argentina + Brazil, their joint agricultural land is 11 times the size of that of France. Argentina is now China's third food supplier. The "westernisation" of China's diet has opened the doors for the export of wine, beef and dairy products. State-owned Beidahuang State Farms Business Group (China's leading soya producer) will invest US\$ 1.4 billion in Province of Rio Negro to develop 320,000 hectares of currently unusable land: the harvest yielded is guaranteed to go to China for the next 20 years

Argentina is paying a heavy price in developmental terms because of its unstable and unpredictable macroeconomic context: it could have diversified its exports, instead, these are increasingly soya-dependent, with China as main market. For this to happen, it should have improved its infrastructure and improved the skills and education of its workforce.

China seems the only investor willing to invest in such an unstable environment: the risk becomes justified when the priority is to feed the most highly populated country in the world. This is a strategic investment in infrastructure: "You (China) have the market and the money, we (Argentina) have the climate, the land and the environment". This policy allows China to enter Argentina's agriculture and food sector without being at the mercy of the market.

The next 5 years will see investment of US\$850 million to bring irrigation and energy (there is already a hydroelectric power plant nearby developed by the central government). A further US\$ 500 million will be spent to develop infrastructure in Rio Negro, mostly to develop port at San Antonio-Este (just south of Viedma in att. map: note strategic location vis-à-vis Falkland Islands), which China will have the right to use for next 50 years: dock capacity to be increased to allow entrance of Chinese vessels weighing 40,000 tons (four times the size of ships currently access the area).



Argentina also provides a model of Chinese investment which is very instructive as an example of long-term, strategic thinking and which should be studied for its possible relevance to Europe, as China begins to employ in Europe stratagems which have served it well in developing countries. China is currently negotiating to invest \$1.4bn in the energy sector in Argentina, a sector recently made less attractive to Western investment by President Kirchner's clumsy nationalisation of the Spanish company, Repsol's, interests in Argentina. Part of the deal is for China to take charge of 3,400 hectares of land for 20 years, the agricultural produce of which will go to China. As noted in the above paragraph, China will also develop (with imported Chinese labour) an adjacent port which it will run on a 50 year lease and all the necessary infrastructure inland. The local farmers will be paid \$200 per hectare today, but must repurchase the land after 20 years at the then market value plus the value of the infrastructure China will have built on it by then. If they cannot pay, the land will revert to China.

China and Brazil

China's relationship with Brazil is pivotal. The two countries have formed an alliance in the World Trade Organisation. Beijing is supporting Brazil's bid to become a permanent member of the United Nations Security Council. China got Brazilian backing for its application to join the Inter-American Development Bank. Membership gives Chinese companies privileged access to infrastructure and other projects financed by the bank. In 2009 China contributed US\$ 350 million to the IADB.

In 2009, total trade between Brazil and China had amounted to \$3.2bn (£2.14bn), representing a near twelve-fold increase since 2001. The US has been Brazil's principal trading partner for nearly 80 years, but a sudden surge in Chinese demand for Brazilian iron ore in the first quarter of 2009 dislodged the Americans. This news is the latest sign of China's increasing challenge to US hegemony in Latin America. China has been steadily increasing its sphere of influence and has become particularly close to the four "Red" South American countries: Venezuela, Bolivia, Ecuador and Peru.

Brazil's trading partners: EU27 represent 20.8% of Brazil's exports and imports, followed by USA (15.4%) and China (14.7%). China becomes Brazil's second trading partner for exports after the EU 27. Brazil said it now aimed to diversify its range of products to China. Currently the bulk of Brazilian exports is made up of soya beans (for Chinese tofu), iron ore, cellulose and fuel.

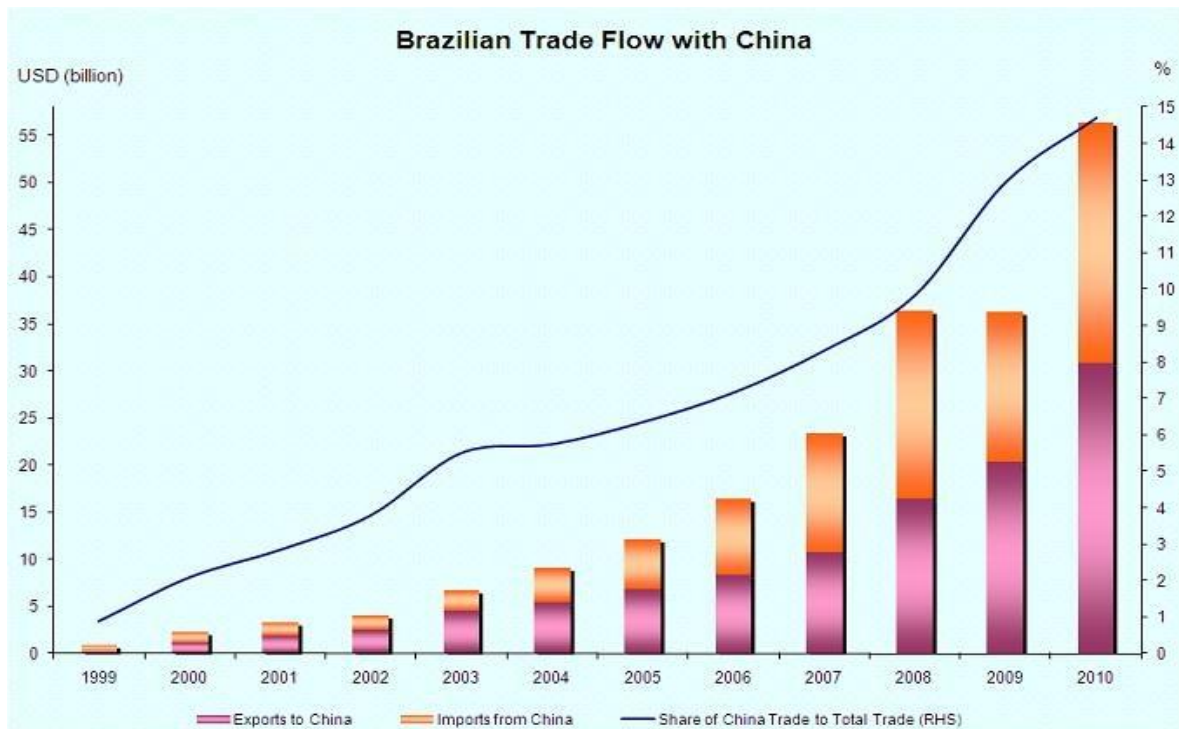
State-owned Chinese companies are currently in discussion with at least six Brazilian states to guarantee their ability to buy soya directly from the producers. The biggest investment is being carried out by the Chinese state-owned Sanhe, reportedly prepared to invest US\$ 7.6 billion over the next decade in order to boost agriculture and logistics in Brazil's central state of Goiás, in return for guaranteeing an annual supply of 6 million tons of soya.

In 2012, China and Brazil agreed a currency swap deal for US\$ 30 billion in a bid to safeguard against any global financial crisis and strengthen their trade ties. It will allow their respective central banks to exchange local currencies worth up to 60bn reals or 190bn renminbi (\$30bn; £19bn). The amount can be used to shore up reserves in times of crisis or put towards boosting bilateral trade (BBC News, July 2012). Analysts said that Beijing has been trying to push for trade to be settled in renminbi, rather than in US dollars, as part of its plans to seek a more global role for its currency.

China and Brazil have also announced that they will work closely in mining, industrial, aviation and infrastructure development. The deal includes joint satellite launches, shared research on nanotechnology and cooperation in the field of oil and gas.

- It would involve more trade diversification, including Chinese purchases of aircraft made by Embraer, a Brazilian manufacturer and Chinese investment to build oil
- drilling platforms in Brazil. The two countries will also jointly launch two satellites, one this year and another in 2014 and set up culture centres and language networks in each other's countries.
- Lenovo, the world's No. 2 PC vendor, says it expects more than 20% of the next half-billion PC buyers to be in Brazil. The company, which surpassed Dell, in part because of a push into markets including India and Russia, says its Brazil operation is now its biggest outside of China.
- Lenovo has 4,000 employees in Brazil. It has just completed the acquisition of local electronics brand CCE for 300 million Brazilian reals (\$146.5 million) and is already building a \$30 million plant.
- Lenovo hopes the acquisition of CCE, a lower-end brand, and being more competitive on prices will boost its business in fast-growing, less wealthy regions of the country.
- Brazil is like a "blank slate" because competitors "may not see the Brazil opportunity as big enough to go through the trouble of such fundamental changes," says Dan Stone, head of Lenovo's Brazil business. From acquisitions to new manufacturing and research facilities, "we are making more investments in Brazil than in any country outside of China."
- Meanwhile, Tencent Holdings Ltd. the operator of QQ, the most popular instant-messaging service in China, has launched a Portuguese version of its growing private-messaging mobile application Weixin, called WeChat in English. The company declined to elaborate on its

efforts. Right now, San Francisco-based WhatsApp is the most popular smartphone private-messaging service in Brazil.



China and Cuba

- Cuba is turning to Chinese companies rather than western ones to modernise its crippled transportation system at a cost of more than \$1bn
- Beijing is Cuba's second trading partner after Venezuela.
- Buses come from the Yutong Bus Company. Cuba's ports are being revamped with Chinese equipment, in part, to handle millions of Chinese domestic appliances that began arriving in 2005. Oil rigs along Cuba's northwest heavy oil belt boast Chinese flags.
- China has provided Cuba with about \$500m in trade cover to develop communications and electronics. But direct investment between the countries is only about \$100m.
- Western companies such as Volvo, Mercedes-Benz, Alstom, Toyota and Fiat, entered the Cuban market through representative and subsidiary companies in the 1990s with an eye to supplying the growing tourist industry and replacing Soviet equipment if Havana ever had the cash. But it was China that benefited most from Cuba's economic situation.

China and Ecuador

Ecuador provides an example of predatory Chinese behaviour. Ecuadorian oil-services company Dygoil SA won a \$69 million contract to upgrade wells for Ecuador's state oil company, Dygoil's

financing options were dire: no international credit, local banks were changing interest rates of up to 20% annually.

So Dygoil turned to China National Petroleum Co., which had access to borrowing rates of 3% to 4% from the Bank of China. CNPC agreed to come in as an investor. But just before the project began, CNPC decided to work alone and reduced Dygoil to a subcontractor

China and Chile

China's engagement with Argentina, which is based on a medium and long term investment strategy, dovetails neatly with its shorter term investments into the mineral resources of Chile and Peru. Not only has China now secured through these investments direct access to and control of in excess of 50% of the world's copper resources, it has also developed a nexus of influence in the Southern and Western half of the Latin American continent which will serve it well in the longer term. As with Japan in the 1960s and 1970s, but on a vastly larger scale China is investing and making its strategic decisions based on a timescale of return of perhaps 50 – 75 years. The Chinese investments so far in Latin America outstrip those in Africa perhaps by as much as one hundredfold and the underpinning of the Argentinian peso should be seen in just that context.

- Chile was the first Latin American country to sign a free trade agreement with China: 92% of Chilean products enter the Chinese market without paying tariffs
- China is Chile's first trading partner.
- Chile is a member of APEC, the grouping of Pacific Rim countries, and the mayor of Shanghai was recently in Santiago at the end of September discussing closer cooperation.
- Beijing has invested in energy in Brazil and Argentina (though CNOOC's purchase, with its Argentine partner Bidas, of a 60 per cent stake in Pan American Energy from BP is reportedly veering towards the rocks).
- Chinese Ambassador to Chile Lu Fan said Washington's proposed trans-Pacific partnership, a multilateral free trade agreement that aims to integrate the economies of the Asia-Pacific region, is based on changes in Asia but is also influenced by concerns over the development of China-Latin America relations.
- The US wants China's cooperation with the region under its control since for Washington the region is its 'backyard'. That is a factor that Beijing has to take into consideration when drawing up its Latin American policies.

China and Peru

The most troubled Chinese investments are in Peru. Shougang International Trade & Engineering Co.'s purchase of Peru's state-run iron works, Hierro de Peru. The Chinese firm paid \$120 million for the mine in 1993, five times the price of the closest bidder, and pledged another \$130 million in investment. In another case, townspeople in San Juan Marcona buzzed with talk about how China would revive the dying Pacific port. A decade later, the town of 13,000 faces ruin. Last June, scores of workers blocked a highway to demand a pay raise of 85 cents a day and a daily ration of canned milk. Many were fired.

ANNEX C

Contributors

Samantha de Bendern

Chris Donnelly (Team Leader)

Alex Finnen

Babak Ganji

Dan Lafayeedney

David McOwat

Alan Riley

James Sherr

Celia Szusterman