Global Economic Policy Lab

Sino-Russian Integration: A Threat to the West or Putin's Pipe Dream?

Russia Analysts
Farley Sweatman
farley.sweatman@mail.utoronto.ca

Trevor Yip
trevor.yip@mail.utoronto.ca

Carlo Muia
carlo.muia@mail.utoronto.ca

Anthony Moniuszko
anthony.moniuszko@mail.utoronto.ca

Lab Director
Professor Mark Manger
mark.manger@utoronto.ca

munk school
OF GLOBAL AFFAIRS & PUBLIC POLICY

UNIVERSITY OF TORONTO

- Russia's deteriorating relationship with the West has prompted its leadership to explore the prospect of enhanced cooperation with China
- Despite lofty trade titles and political rhetoric, concerns over economic interdependence between the two countries are overstated
- Any economic integration of note between the countries has been mostly limited to trade, meanwhile investment and other indications of economic integration remain low between the two countries
- Fundamental imbalances deter broad-based bilateral investment and any meaningful attempt at integration
- China has significantly more to gain in a long-term scenario where Russia and China do become more economically integrated

Overview
Russia's Pivot from "Greater Europe" to "Greater Eurasia"

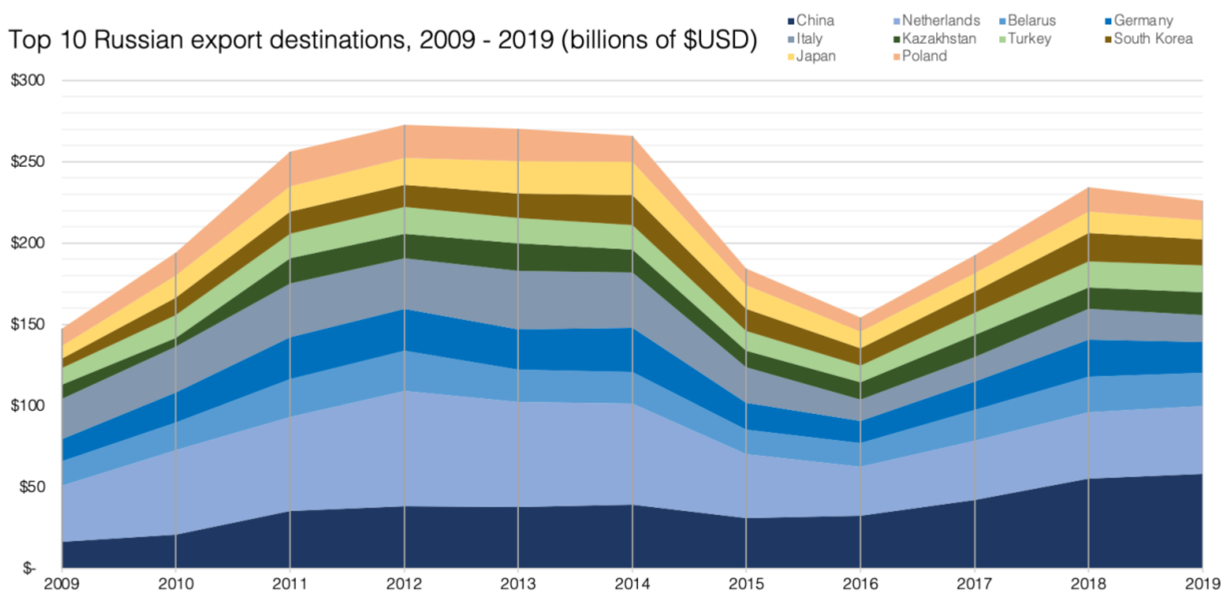
On December 2, 2020, Russian Prime Minister Mikhail Mishustin hosted the 25th regular meeting of Russian and Chinese heads of government with Li Keqiang, Premier of the State Council of China, to promote cooperation in investment, industry, energy, agriculture, and transport. Prime Minister Mishustin discussed efforts to merge China's Belt and Road Initiative (BRI) with the Russian-led Eurasian Economic Union (EAEU) by establishing "a system of digital corridors between the five Union member countries" and creating "favourable conditions for introducing electronic certification in mutual trade."

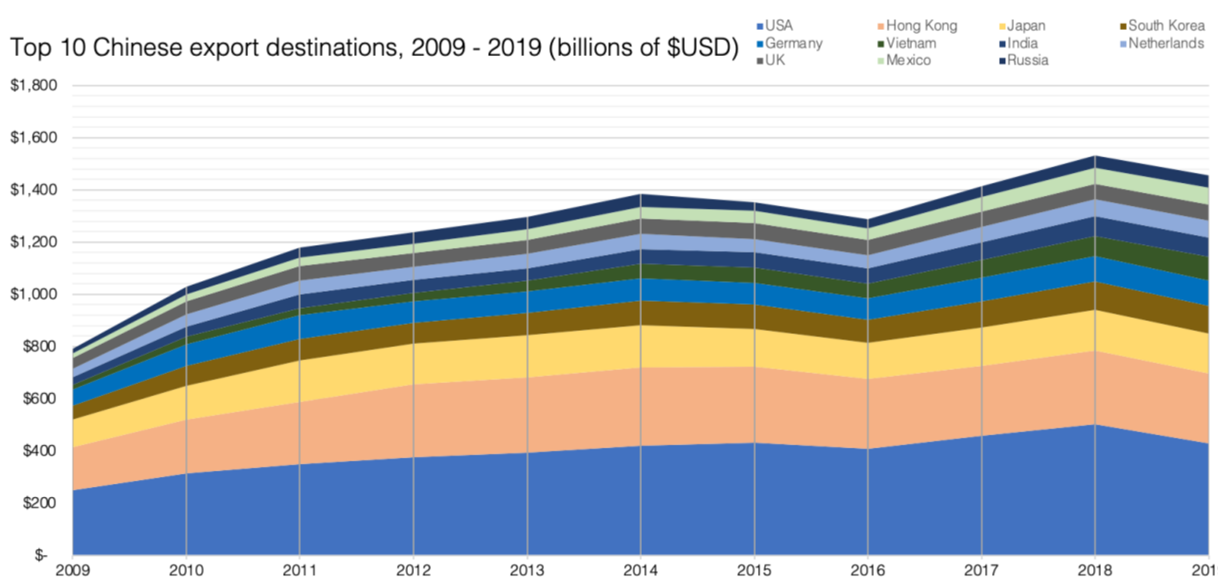
The notion of enhanced Sino-Russian trade and investment is reflective of Russia's deteriorating relationship with the West and its gradual pivot from Europe toward Asia. Prior to the Crimean annexation, Russia paid very little attention to Asia, being more vested in Europe and the West from an economic and cultural standpoint. The geopolitical rationale for a 'pivot' towards Asia became apparent after the annexation and subsequent Western sanctions, but even after their imposition, Russia's attempts to reach out economically to Asia have largely remained instrumental and of limited scope. Thus far, it has appeared to view economic initiatives with Asia, such as the EAEU, as a failsafe rather than a priority, or in other words, a means of counterbalancing the West when relations sour. As late as 2019, support for possible BRI-EAEU integration has progressed little beyond the rhetorical level for both Beijing and Moscow.

While Russia's Asian overtures aim to harness the region's economic dynamism by integrating it with the Russian economy, its efforts have not only been undercut by Western sanctions and China's growing influence in Central Asia, but also by the lukewarm reception it has garnered from China and other Asian states. For example, Chinese private banks, alongside their Japanese and Korean peers, have tacitly complied with US sanctions and largely refrained from investing in Russia. In 2018, Russia accounted for a paltry 0.5 percent of all outbound Chinese investment, and much Chinese investment in Russia is conducted by state-owned banks as a result – many of which charge far less favorable rates for Russia. In short, the fundamental nature of the Sino-Russian economic relationship remains as unpromising as it was prior to the COVID-19 pandemic.

Trade, Investment, and Security

Even though Russia and China are long-lived trading partners, significant trade disparities between the two countries indicate that their trade relationship heavily favours Beijing over Moscow. For instance, even though the overall value of bilateral trade has been steadily increasing between the two countries in the last 10 years, with Putin announcing the goal to reach an annual trade value of USD 200 billion (nearly double of what it was in 2019), Russia is much more reliant on China than vice versa. In fact, as of 2019, 14.3 percent of Russian exports were destined for China, and 19.8 percent of their imports came from China. In contrast, just 1.8 percent of China's exports in 2019 were destined for Russia, and just 3.4 percent of their imports came from Russia.

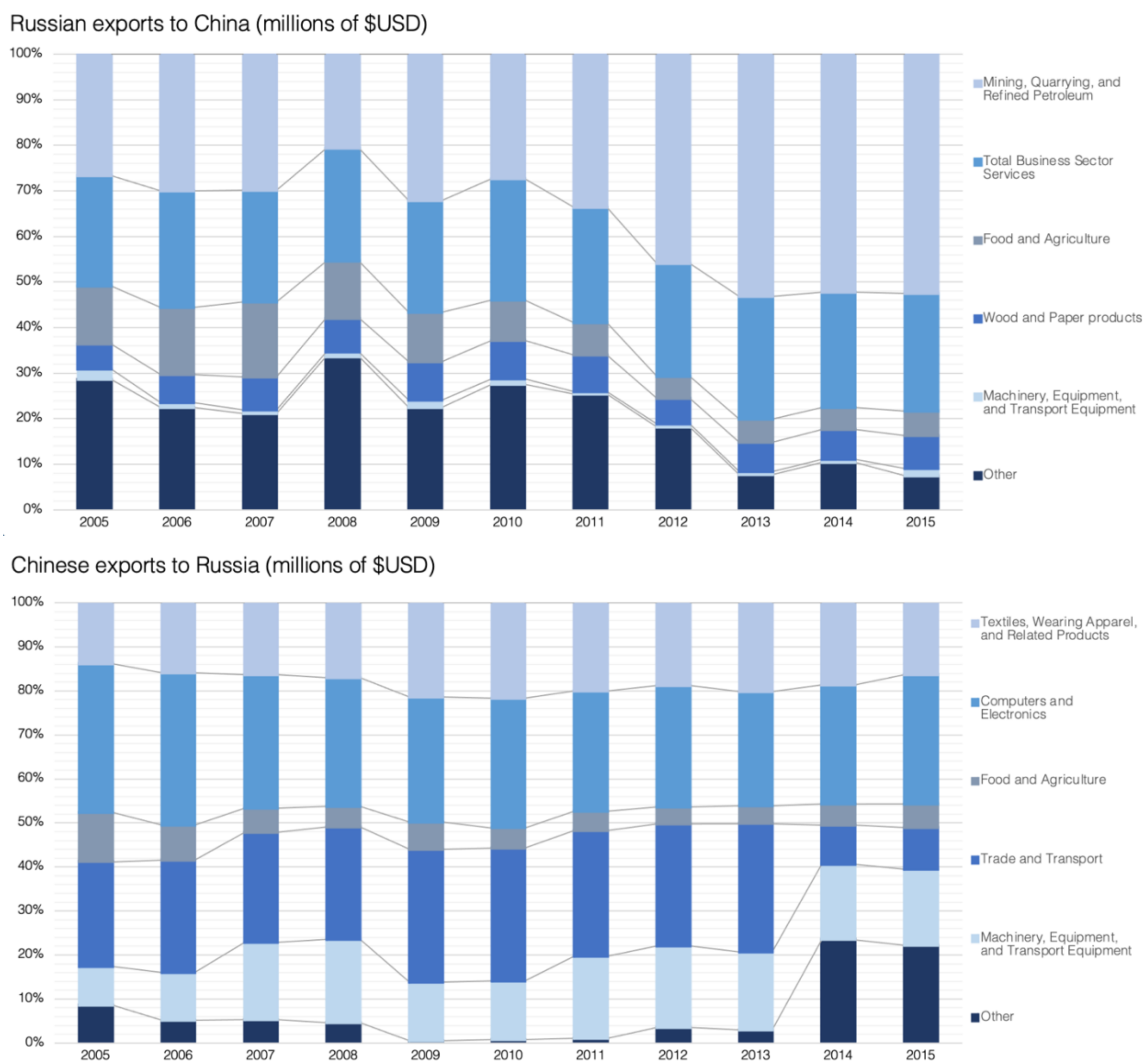




Source: OEC, GEPL Calculations

Meanwhile, over 35 percent of Russian exports to China consist of fossil fuels, such as oil, petroleum products and coal. As such, Russia's exports to China could dramatically fall as Beijing transitions to a low-carbon economy starting from as early as the next decade. Therefore, not only does China have much more leverage power that it could use during trade negotiations or investment deals with Russia, but it could also inflict a heavy blow on the Russian government's revenues. In order to avoid this, Russia must diversify its trade relationship with China, perhaps by leveraging its newly discovered comparative advantage (mostly climate change driven) in agricultural production, including its booming wheat exports.

Structure of bilateral trade in value added exports between Russia and China, 2005 - 2015



Source: OECD TiVA, GEPL Calculations

While Russia could benefit from deeper cooperation with China in terms of infrastructure and other projects Eurasia, the country's weak market fundamentals (corruption, low diversification, and poor infrastructure above all) have hampered the success of Sino-Russian investment projects, as demonstrated by the fact that all 40 transportation projects proposed by the EEU in 2017 were rejected. Chinese FDI in Russia remains low when compared to other Asian countries, having only invested USD 27 billion between 2015 and 2020. Within the same time frame, China has invested USD 44 billion in Australia and USD 38 billion in Pakistan. This failure to attract Chinese FDI is further illustrated by Russia's 20 special economic zones (SEZs) in its Far East – only six of which have attracted Chinese investment, totaling a mere USD 38 million between 2015 and 2018.

Finally, deeper cooperation with China is highly driven by Russian isolation due to Western sanctions. However, in 10 to 15 years, security concerns over China's coercive practices might force Russia to take a step back, try to improve its relations with the west, and distance itself from China. If Russian economic dependence with China continues to increase (and remains heavily concentrated on oil exports) to the detriment of trade and investments with the EU and other western countries, distancing from Beijing will prove either unfeasible or catastrophic for the Russian economy.

Barriers to Integration

Economic asymmetry and geopolitical inconsistencies deter broad-based bilateral investment and any meaningful attempt at Sino-Russian integration. Bilateral investment is limited due to fundamental imbalances between the two countries. Denoted by the structure of bilateral trade in value-added exports, Russia's economy is largely resource extraction-based, which deters broad Chinese investment. Conversely, there is little rationale for Russian investment in the more diversified and balanced Chinese economy.

This imbalance has even impeded integration over common ground. Eager to reduce their dependence on Western financial systems, China and Russia began using their own currencies for bilateral trade in 2010 and opened their first currency swap line in 2014. There have been efforts at linking their respective national payment systems for several years; however, cooperation on the digital payment front remains curbed by Russia's comparatively small market, aversion to digital currency, and limited global soft power. Whereas China's UnionPay cards can be used globally, Russia has struggled to get its Mir card system to work internationally beyond the EAEU.

In terms of geopolitics, China's potential to create a one-sided dependence with Russia has prompted both countries to act contrary to their supposed alliance. Enhanced Sino-Russian cooperation risks derailing Russia's decades-old economic relationship with India, which is centered around arms sales. Russia's frequent diplomatic overtures about a possible FTA between India and the EAEU can be perceived as an attempt to balance Chinese economic influence.

Moreover, the authoritarian makeup of both countries limits bilateral transparency and cooperation. Their common preference for government control over information has restricted data flows. Seven of China's eight long-distance international terrestrial cables run through Russia. This infrastructure has the potential for serving as a larger communications hub between Europe and China; however, their respective visions for 'internet sovereignty' requires storing personal data domestically and installing applications on domestic equipment, among other restrictions.

Medium-to-Short Term Predictions

As the world recovers from the COVID-19 pandemic, GEPL predicts that the reinvigoration of the Chinese economy – the only major economy to have exhibited positive growth in 2020 – will not be sufficient to lift the Russian economy alongside it. As seen in the graphs above, this is due to fundamental imbalances in Sino-Russian economic relations: Russia simply does not sell enough to China due to a lack of economic diversification, and Chinese (private) investment remains limited due to US sanctions and the difficulty of doing business in Russia. Slowing Chinese growth and the absence of cash transfer programs to Chinese citizens throughout the pandemic may limit the rebound in Chinese consumer demand for quite some time. Although Russia's agricultural sector has hitherto been competitive globally, GEPL does not expect exports to increase in the short term (whether to China or otherwise), due to production in 2020 having been disrupted by an unusually warm summer, while simultaneously being hampered by pre-existing (and new) export quotas/taxes and an increase in domestic demand for food during the pandemic; this and rising food prices will inhibit Russian imports overall during the recovery.

Although the EU remains Russia's largest trading partner, it will become increasingly difficult for Russia to compensate for its trade deficit with China through them, owing to Western sanctions and a possible long-term decline in European demand for Russian energy. Trade with Russia's traditional periphery will also remain unpromising, due in part to China's increasing influence: initiatives such as the EAEU are considered too protectionist compared to the BRI by many Central Asian states. A competition for influence, given that local players are reluctant to choose between Russia and China, will further constrain Russia's outreach efforts. GEPL therefore predicts that Russia's economy will not become more interconnected with China's for the foreseeable future due to economic incompatibilities and a mutual disinterest for comprehensive integration, whether as a result of geopolitical concerns (Russia), unpromising returns on investment (China), or simply being economically focused elsewhere (both).