Analytical Report

Sino-Russian Cooperation: Finding Ways to Each Other

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Sino-Russian Cooperation: Finding Ways to Each Other

The relationship between China and Russia is an important part of global current affairs and has been rapidly evolving in recent years. While most of the attention of international policy, media, and business circles has been focused on the strategic relationship between Moscow and Beijing, the state of Sino-Russian economic and commercial cooperation has been largely overlooked. In a joint report, two leading credit rating agencies from China and Russia, CCXI and Expert RA, put efforts to attract attention to these issues. China and Russia are the leading players on the global stage, their mutual interdependency is emerging, and the problems and prospects of their economic cooperation should be thoroughly analyzed.

Both China's and Russia's economies are facing downward pressure

China is the leading global economy: in 2018, its GDP based on purchasing power parity was the world's second largest. Even though China's GDP growth rate has been gradually declining over the last decade and reached 6.6 percent in 2018), it remains within government-set targets and is still one of the strongest globally. Nevertheless, the Chinese leadership faces a significant challenge to restructure the economic growth model and implemented the supply-side economic reform, which was proposed in 2013 and initiated in 2015. Among the sectors with the highest growth potential in China are information technology and artificial intelligence, electronic commerce, and the service sector. Among the external challenges for the Chinese economic system, one of the most pressing is the currently ongoing trade dispute with the United States, which creates uncertainty for both Beijing and Washington, and for foreign and domestic investors in both countries.

Russia is showing noticeable signs of slowdown in economic growth: it experienced a 2.3 % GDP growth in 2018 with a forecast of a further slowdown to 1.5% in 2019. This is largely due to a tough combination of fiscal consolidation and inflation targeting implemented simultaneously by the Russian regulators. Russia's weak institutional climate remains a remarkable obstacle for its business and investment development, which impedes its growth. Nevertheless, comparatively higher prices for natural resources have been providing relative economic stability, high reserves, and low external debt in Russia. Western sanctions against Russia, however, are creating significant external risks for the Russian economy from the long-term perspective, by limiting its access to financing and technological know-how. The Russian energy sector, the largest source of wealth for the state budget, suffers from sanction pressures the most.

Current economic cooperation between Moscow and Beijing remains unbalanced

In this challenging environment for both Moscow and Beijing, the complementarity of the Russian and Chinese economies is growing. However, economic cooperation between Moscow and Beijing remains unbalanced and concentrated around a specific group of sectors.

- China has been Russia's first trade partner since 2010 (as a nation-state), while Russia was the 10th trade partner for China in 2018. The trade turnover between China and Russia has been growing fast over the last five years and showed a 27.1% increase in 2018, reaching $107bn. Nevertheless, most of this growth can be attributed to a "low-base effect": bilateral trade plummeted in 2014 amid the first rounds of anti-Russian economic sanctions introduced by western countries and the volatility of the ruble. While China is the leading supplier of machinery, electronics, and consumer goods to Russia, 60% of Russia's exports to its eastern neighbor are hydrocarbons. Also, Russia has supplied considerable amounts of arms to China: there is a contract for the supply of six S-400 missile systems (the contract value is $3bn) and the supply of 24 SU-35 air fighters (the contract value is $2bn) from Russia to China.

- Sino-Russian investment cooperation has also seen unbalanced development with its concentration on a small number of industries and regions, and the scope and depth of bilateral investment needs to be further extended. Despite the positive relationship between Moscow and Beijing, Russian FDI to China is very limited in scale and mainly flows to the wholly owned subsidiaries of Russian companies in China. In 2017, the amount of Russian FDI to China reached $33mn, which was a considerable increase from just $6mn in 2016. Meanwhile, China's FDI to Russia grows at a comparatively slow pace and is subject to some volatility (Russia's share among Chinese FDI globally has rarely exceeded 1 percent). In 2017, the yearly Chinese investment in Russia reached $1.5bn, bringing the total number to $13.9bn, but the FDI was skewed toward natural resources and partially toward transport infrastructure construction. The largest investments of Chinese companies in Russia took place at Novatek's Yamal LNG project in the Russian Arctic: Chinese National Petroleum Corporation and the Silk Road Fund invested $2.2bn in the project. Also, two Chinese companies, Sinopec and the Silk Road Fund, invested $2.4bn into Sibur, one of Russia's largest petrochemical companies. In order to attract more Chinese FDI into different sectors of the Russian economy, the Russian government has created various special economic zones in the Russian Far East. There are various investment support mechanisms within 200km of the Chinese-Russian border, but the flow of Chinese investments has been modest so far due to issues with the Russian institutional environment.
- In addition, Sino-Russian bilateral cooperation in capital finance, albeit significantly strengthened in recent years, is still in its infancy. In order to avoid exchange rate risks and improve the convenience of bilateral trade, bilateral currency cooperation is steadily advancing. In November 2017, China and Russia renewed the currency swap agreement of 150bn yuan / 1.325tn rubles, and the Sino-Russian currency swap line reached 943bn rubles in the first 10 months of 2018, about 1.5 times that of 2017. However, the currency swap has not yet been used broadly, and the U.S. dollar is still the main settlement currency in bilateral trade. Furthermore, the local currency settlement between banks of the two countries is largely related to remittances.

Sino-Russian cooperation still faces multidimensional constraints

At the macro level, against the background of subdued global growth, as well as the increasingly complicated and uncertain international situation, China and Russia are facing several downside risks.

- In the case of China, the long-standing trade dispute with the U.S. has put pressure on its exports and investment. In addition, although the Chinese government's deleveraging measures have achieved some progress, with the policy shift to strengthen fiscal stimulus, government and public sector debt has further increased, and the domestic market still faces a high leverage ratio. It is also more difficult for the government to deleverage in the context of an economic slowdown. Furthermore, the traditional attractiveness to foreign investment of Chinese cheap labor has also weakened, making the Chinese market less attractive to foreign capital.
- Sanctions are the main challenge for Russia as they raise uncertainty and political risk, and significantly affect the country's economy through the exchange rate, capital outflow, and interest rates. However, western sanctions have created an environment for Moscow's closer cooperation with eastern countries (the so-called 'pivot to the East'). However, they complicate Russia's relations with the eastern states as well, including with China. Political sanctions against Russia and the Russian institutional environment, where formal and informal "rules of the game" often appears unclear to Chinese investors, obstruct the Sino-Russian investment and business relationship to a significant extent.

- The institutional environment also matters in bilateral cooperation and has significant room for improvement. While legislation on both sides is becoming more favorable, bureaucracy and the great number of informal practices places prohibitive hidden costs on both investors and businesses.
- Information asymmetry appears to be a more direct factor restricting the development of bilateral cooperation. Investors in both China and Russia lack a comprehensive understanding of the current situation of bilateral economic development and the trends in industrial development, and the mechanism of information interconnection is not yet smooth. Furthermore, political factors could distort the risk assessment of specific enterprises, given that some sanctioned Russian companies are financially strong and bear a low credit risk.

Despite the constraints of Sino-Russian economic and trade cooperation, there is still huge room for the development of better bilateral cooperation

Traditional cooperation in the energy and infrastructure fields is still of great importance considering the two countries' energy structures, and cooperation in other fields such as high-tech, e-commerce, agriculture, as well as the financial sector have significant growth potential. Some of these areas have already made encouraging achievements.

- After western financial institutions withdrew due to the risk of sanctions, the Russian energy sector has faced a large financing gap. Meanwhile, China's resource structure determines that the country's crude oil supply must rely on imports, and Russia has become China's largest crude oil supplier since 2013. In addition, China is undergoing a transformation toward clean energy consumption, which generates greater demand for natural gas, while Russia is able to actively expand its share of China's natural gas market. For example, supplies of natural gas through the Power of Siberia pipeline are scheduled to start in December 2019. Also, Novatek has already started supplying LNG to China from its Yamal LNG project in which Chinese investors hold 29.9% of the shares. Chinese companies also supplied crucial LNG equipment for Yamal LNG. With the adjacent geographical advantages and complementary supply and demand structures, there is still a huge room for China and Russia to deepen their cooperation in the energy field.
- Infrastructure modernization is one of Russia's top priorities, and China has advantages in terms of technical skills and financing. China's participation in Russian infrastructure projects has increased since 2014. There are Chinese companies currently engaged in the building of several stations for the Moscow metro, being the first ever foreign contractors invited by the Moscow government for this purpose. Additionally, Far Eastern infrastructure projects seem to have significant potential for strengthening Sino-Russian cooperation. For example, the construction of the first rail bridge connecting Russia and China across the Amur River was completed in April 2019.
- The high-tech field holds a lot of potential for Sino-Russian cooperation. Several fruitful joint achievements in aerospace, nuclear energy and other fields have been made. The Russian company, Rosatom, has been successfully developing cooperation with the Chinese side by participating in the construction of "Tianwan" nuclear plant since 2007. Russian United Aircraft Corporation and Chinese Comac, two leading aircraft manufacturers in Russia and China, are jointly working on a long-range wide-body twinjet airliner – CRAIC CR929. In addition, there is the potential for the development of electronic commerce cooperation between China and Russia. In 2018, Alibaba Group, China's most prominent e-commerce platform, acquired a 10% stake in Mail.ru Group. In 2019, Mail.ru, Megafon, Alibaba, and the Russian Fund of Direct Investment (RFDI) established a joint venture called "AliExpress Russia",

which sets out to encompass the Alibaba Group's Russian business (AliExpress and TMall) and covers the audience and investment from Mail.ru Group and Megafon, and the investment from the RFDI. Alibaba Group's share in the joint venture is 48%; Mail.ru has a 15% stake; Megafon – 24%; and, RDFI – 13%. This project promises to become the leader in Russia's electronic commerce and will provide Russian small and medium-sized businesses with exposure to the Chinese market.

- Amid the growing demand for high-quality agricultural goods in China and the ongoing trade war between Washington and Beijing, which puts limitations on Chinese agricultural imports from the U.S., Russia could become a major destination for China's agricultural investments. The Russian Far East is located in the immediate geographical proximity to China and could potentially become one of the largest recipients of China's outward agricultural investments due to the low land rent and low prices for energy in the region. Also, Russian agricultural companies are now facing a window of opportunity to increase their exports to China due to the relaxation of regulatory restrictions from the Chinese side. In April 2019, 30 Russian producers received the Chinese authorities' approval to export poultry to China, which could lead to an increase in exports by 150.000 tons annually. Amid the U.S.-China trade war, Beijing put tariffs on American soy, which also gave an opportunity for Russian agricultural producers to increase their soy exports to China. In the future, the Russian authorities are planning to push for the approval of Russian pork exports to China, which could create a tremendous business opportunity for Russian producers.
- A potential avenue of financial cooperation could be the more active involvement of Russian companies in China's bond market. Against a backdrop of limited financing in the European market, in addition to continuously deepening local ruble market financing, expanding financing channels will become a strategic choice for Russian enterprises. With the internationalization of the RMB and the further opening up of China's capital market for Russian enterprises with cross-border capital flows or business, the issuance of Panda bonds in China's on-shore market , and along with dim sum bonds and dollar bonds in the off-shore market may help to optimize their debt structure and achieve lower-cost financing. Rusal is the Russian "forerunner" for issuing Panda Bonds, which successfully issued its first Panda Bonds on China's exchange market in 2017, becoming the first Russian company to tap into the Chinese bond market.

Rating agencies' role in risk evaluation and reducing information asymmetry is essential

In order to increase the mutual confidence of the market players and enhance the system of payments in national currencies, credit rating, as a basic institutional arrangement in the bond market, will play an increasingly significant role by helping investors effectively and reasonably identify and evaluate credit risks and reduce information asymmetry. Credit ratings are set to fairly and impartially evaluate various risks affecting the cash flows of investment projects, and in that way help stakeholders to make investment decisions, choose counterparties, determine financing methods, and even allocate or share project risks. Compared with the three major rating agencies in the global realm, CCXI and Expert RA are still in the growth phase and are taking early steps toward globalization. However, years of local rating experiences along with insights into China and Russia's economic environments and political systems, indicates their inherent information advantages as local entities. With a seeming clairvoyance toward the credit risks of various domestic bond issuers, CCXI and Expert RA could help overseas investors understand the business logic of local enterprises and make better risk evaluations.