WORKING PAPER | ISSUE 08 | 18 NOVEMBER 2019

HOW DOES CHINA FARE ON THE RUSSIAN MARKET? IMPLICATIONS FOR THE EUROPEAN UNION

ALICIA GARCIA HERRERO AND JIANWEI XU

China's economic ties with Russia are deepening, particularly in terms of trade and cross-border lending, but less so in terms of Chinese foreign direct investment in, or portfolio flows to, Russia. Meanwhile, Europe remains Russia's largest trading partner, lender and investor. In relation to trade, an analysis of China's increasing export share and the increasing value added of its exports, and previous empirical analysis at the product level, indicate that China seems to have become more of a competitor to the European Union on Russia's market. Increasing competition between European and Chinese exports should not be surprising as there is ample evidence that China has rapidly moved up the technology ladder in the last few decades. Competition over investment and lending is more limited, but the situation could change rapidly with China and Russia giving clear signs of a stronger than ever strategic partnership.

Keywords: trade, investment, cross-border lending, Russia, China, European Union

This paper was prepared for the seminar 'Trade relations between the EU, China and Russia,' co-organised by the Delegation of the European Union to Russia and Bruegel with the support of the EU Russia Expert Network on Foreign Policy (EUREN). The seminar was funded by the European Union.

Alicia García Herrero (alicia.garcia-herrero@bruegel.org) is a Senior Fellow at Bruegel.
Jianwei Xu (jianwei.xu@bruegel.org) is a Non-resident Fellow at Bruegel.

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1 Introduction

The last two decades have seen a very rapid increase in trade and lending between China and Russia. The investment relationship has remained more subdued. China dominates every aspect of the bilateral economic relationship, as a net exporter, net creditor and net investor, despite Russia long being a richer country than China.

China and Russia are increasingly viewed as important political and economic partners, notwithstanding their past differences. However, in terms of trade and investment, economic cooperation between the two countries' remains less intense than their diplomatic relationship, even though their formal economic interactions can be traced back to the 1700s and both shared a similar economic model, namely central planning, for a good part of the twentieth century.

China has developed very rapidly in economic terms over the past two decades since its accession to the World Trade Organisation. In particular, it has become the largest exporter in the world from a very low base (Figure 1 and Table A1 in the Annex), surpassing Europe. In that context, it is unsurprising that Chinese goods have flooded Russia, eating into the EU's and the US's export shares to Russia. Beyond China's increasing economic weight, the changing global environment, including the sanctions and counter-sanctions between the West and Russia, the US-China trade war and the US-led Indo-Pacific Strategy, have helped re-orient Russia's economic relationships towards the east, with China being the largest player.

China has also become increasingly interested in its neighbourhood (and beyond) with its landmark project, the Belt and Road Initiative (BRI). Among the large and increasing number of countries that participate in the BRI, Russia occupies an important position as the recipient of the largest amount of Chinese funding, mainly for energy and railway infrastructure. In particular, out of the six corridors China has announced for the BRI, several cross Russia, including the New Eurasian Land Bridge and the China-Mongolia-Russia Corridor. In addition, Russia and China have agreed to jointly build an 'Ice Silk Road' along the northern sea route in the Arctic. All in all, Russia has unquestionably become an important partner in China's massive global infrastructure project plans. Russia has also proposed the concept of a Great Eurasian Partnership, which is seen as a way for the Kremlin to preserve its relationships within its neighbourhood at a time of very rapid increase in Chinese influence (Köstem, 2019).

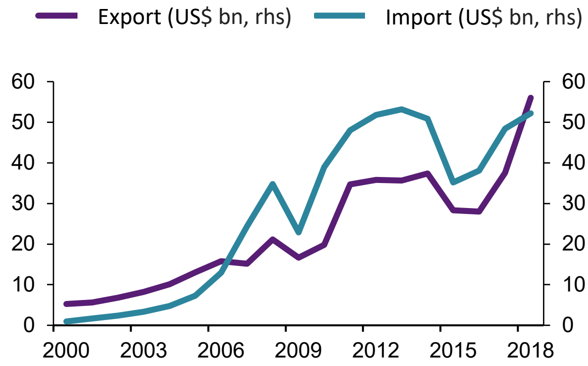
2 An overview of China-Russia economic history

Although strategic cooperation between China and Russia can be traced back to the seventeenth century, their economic interactions have been less prominent for most of their history (Lotspeich, 2006). Trade, lending and to a lesser extent investment flows between China and Russia only became relevant from the mid-1980s when the two countries started to transition from planned to market economies. In the following sections, we offer a brief account of economic bilateral relations since then.

Trade

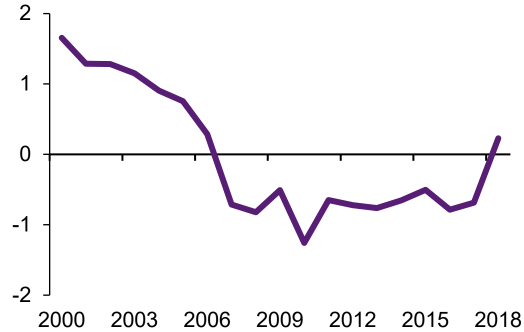
In the 1990s, Russia-China trade was relatively small but even then, China was more important for Russia than Russia for China. According to Chinese statistics, Russia only took 1 percent of China's total exports and provided 2.8 percent of China's total imports, while according to Russian statistics, China took only 4.7 percent of Russia's exports and provided 3.3 percent of Russia's imports. Other than the limited nature of trade between the countries, certainly compared to today, it is important to note that Russia maintained a moderate trade surplus with China during the 1990s (Figure 2)[1].

Figure 1:
Russia's exports & imports to and from China



Source: Bruegel based on UN Comtrade, Russian reported data.

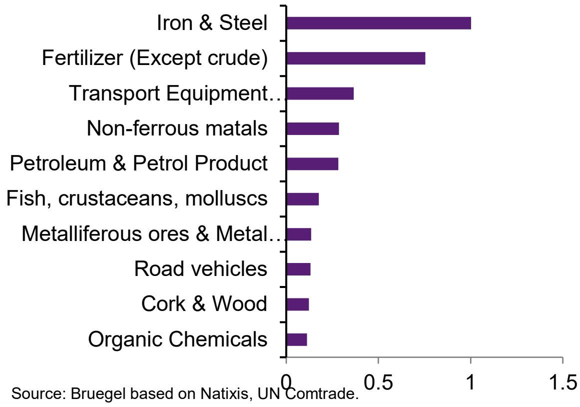
Figure 2:
Russia's trade balance with China (% Russian GDP)



Source: Bruegel based on Natixis, UN Comtrade.

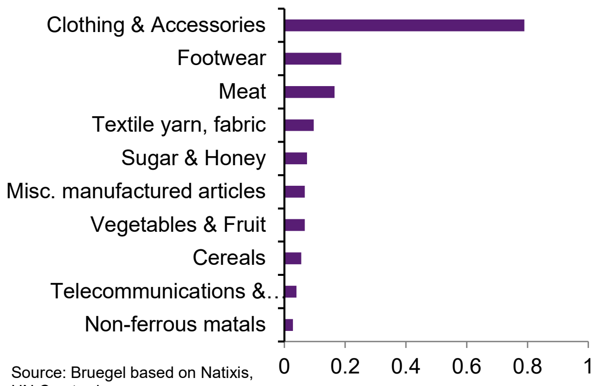
During this period, because of its clearly more advanced position in industrial production, Russia was able to export to China a wide range of goods including raw materials, especially oil and gas, iron, steel, fertiliser and non-ferrous metals, and capital-intensive products such as transport equipment and road vehicles (Figure 3). China's exports to Russia, during the same decade, specialised in traditional labour-intensive products, especially textiles (Figure 4).

Figure 3:
China top 10 imports from Russia ($ bns)
SITC2 Rev.3 Annual Average 1992-2000



Source: Bruegel based on Natixis, UN Comtrade.

Figure 4:
China top 10 exports to Russia ($ bns)
SITC2 Rev.3 Annual Average 1992-2000



Source: Bruegel based on Natixis, UN Comtrade.

The key moment for China's economic development, in the context of its opening-up policy, was its accession to the World Trade Organisation in 2000. Since then, China has witnessed miraculous growth while Russia's economy has stagnated, especially in years of weak commodity prices. In fact, by the early 2000s, China's economy was four times larger than Russia's. Two decades later, China's GDP has reached $13 trillion while Russia's has remained relatively flat and is now $1.6 trillion. In addition to their increasingly unbalanced economic sizes, China's easier access to export markets through its membership of the WTO, and very large inward FDI into the manufacturing sector, have contributed to China's massive increase of exports to Russia. At the same time, Russia's exports to China have grown at a much slower pace, pushing Russia's bilateral trade balance with China to a deficit of around $1.2 billion on average from 2001 to 2014, accounting for approximately 1.2 percent of Russia's GDP but

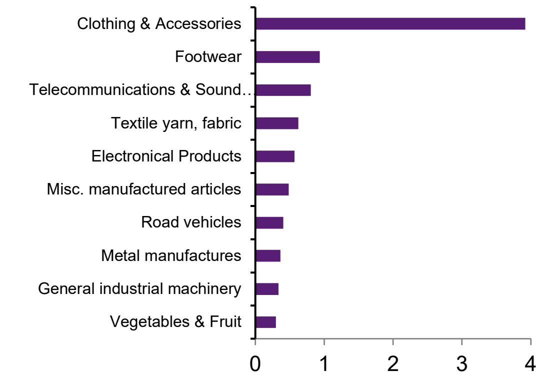
[1] In particular, between 1992 and 2000, Russia's average annual trade surplus with China increased from $1.2 billion to $3.5 billion.

less than 0.03 percent of China's GDP. Russia's trade deficit with China persisted until the dramatic change in 2018 to a surplus of more than $15 billion, because of China's massive imports of oil, contributing 64 percent of the increase in imports (Figure 2).

Generally, China has become more important for Russia since 2000, moving from being the latter's sixth largest trading partner in 2000 to its top trading partner in 2018. In other words, China has now surpassed Germany as a trade partner for Russia, with a trade share of 15.5 percent compared to 9.3 percent for Germany. While the EU is still much more important that China, with a share of 44 percent of Russia's total trade, China is reducing the gap year after year. In turn, Russia has become less important for China since 2007 and only accounted for 0.8 percent of China's total trade (the sum of exports and imports) in 2018. However, the recent large increase in China's oil imports from Russia, if sustained, will make Russia much more important strategically for China.

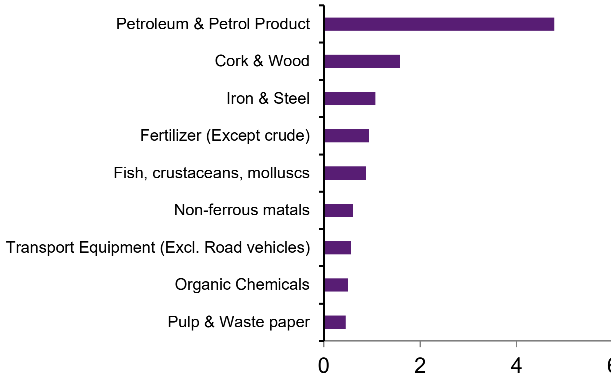
Going beyond gross trade to value added, China has significantly moved up the technology ladder since its accession to the WTO. Most of its exports to Russia are now at a higher technology level than in the past, including machinery and transport equipment, while the share of labour-intensive goods has declined (especially textiles and footwear). These higher-end goods started to show up in China's top 10 list of goods exported to Russia right after China's WTO accession (2001 to 2007), though remaining only small share of the total (Figure 5). Since then, their share has ballooned (Figure 6). At the other end of the spectrum, Russian exports to China have continued to focus on raw materials, especially oil and gas. Although some capital-intensive goods remain among Russia's top 10 exports to China, their importance has declined significantly. This is especially the case of the auto sector, which was the eighth largest export category for Russia from before 2000, but dropped out of the top 10 list after 2000. In turn, China has gradually become a major supplier of autos to Russia (Figures 7 and 8).

Figure 5:
China's top 10 export to Russia ($ bns)
Annual average 2001-07



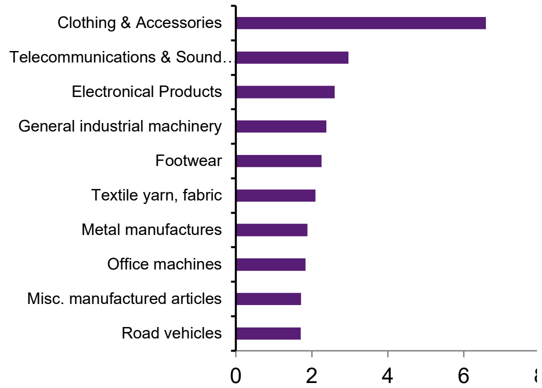
Source: UN Comtrade at the SITC2 Rev.3 classfiication.

Figure 6:
China's top 10 imports from Russia ($ bns)
Annual average 2001-07



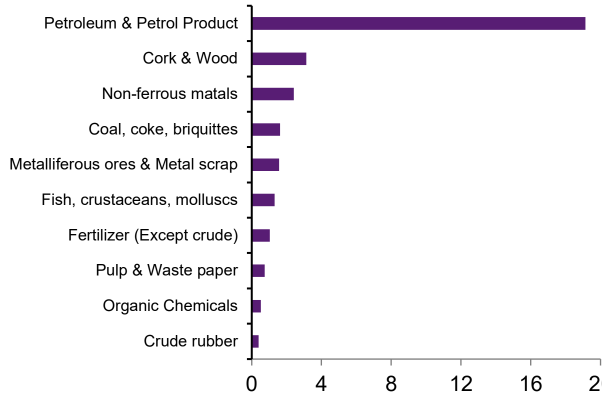
Source: UN Comtrade at the SITC2 Rev.3 classfiication.

Figure 7:
China's top 10 exports to Russia ($ bns)
SITC2 Rev.3 Annual average 2008-17



Source: UN Comtrade at the SITC2 Rev.3 classfiication.

Figure 8:
China's top 10 imports from Russia ($ bns)
Annual average 2008-17

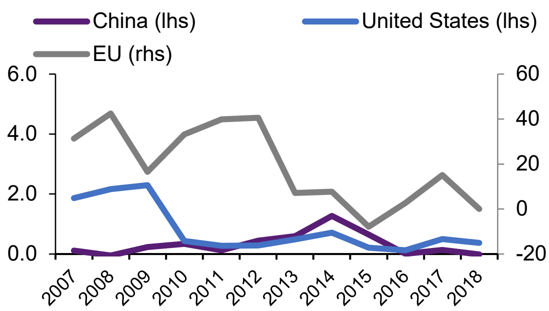


Source: UN Comtrade at the SITC2 Rev.3 classfiication.

Lending and investment

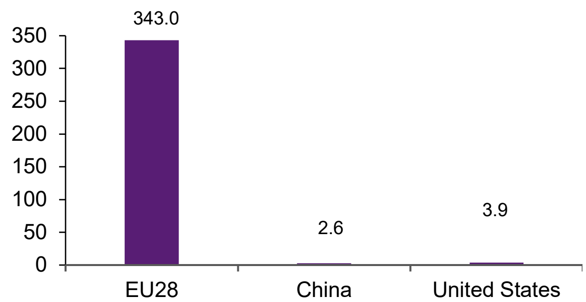
In the last few years, the pace of Chinese outbound investment and lending has accelerated because of increasingly low domestic returns and the need for international diversification. Nevertheless, the amount of Chinese FDI going to Russia continues to be moderate and has actually come close to zero since the peak in 2014 (Figure 9). The stock of China's direct investment in Russia is tiny compared to that of Europe (Figure 10).

Figure 9:
China's FDI flow into Russia
($ bns, 2014-18)



Source: Bank of Russia.

Figure 10:
FDI position in Russia ($ bns, 2018)

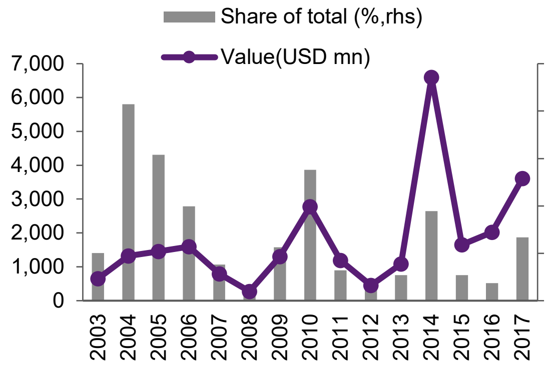


Source: Bank of Russia.

Admittedly, the direct investment statistics are always blurred, because a large share of China's outward FDI is intermediated through offshore centres such as Hong Kong (60 percent of China's total outward FDI is parked in Hong Kong temporarily). In other words, it is quite likely that China's FDI in Russia is underestimated. As a complement to the official data, we also use the transaction-level database provided by fDimarkets.com (for greenfield data) and Mergermarket (for merger and acquisition data) to analyse China's direct investment influence in Russia. The sum of the two yields a significantly larger flow figure of $7.7 billion in 2017, though this is still significantly smaller than FDI from the EU28 reported in official data, eg $15.1 billion.

As for the type of direct investment, China seems to have opted for more greenfield investment rather than mergers and acquisitions (M&A). In fact, Chinese greenfield investment in Russia has significantly increased since 2012 (Figure 11). In three of the five years from 2012 to 2017, the value of Chinese greenfield investment in Russia amounted to more than half of its greenfield investment in the EU28 and even the United States (Table 1). In other words, given Russia's relatively small economic size, the scale of Chinese greenfield investment is quite impressive. An industry breakdown of this investment further indicates that China is focusing on Russia's traditional comparative advantages: the industrial and automobile sectors, and raw materials such as oil, metal and coal.

Figure 11: Chinese greenfield investment in Russia



Source: fDimarkets.com.

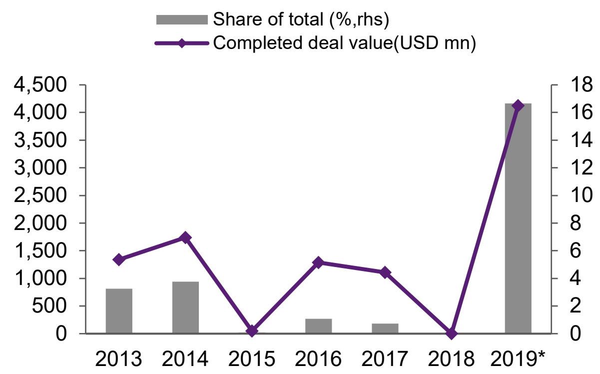
Table 1: Share of China's total outbound greenfield investment (%)

Year	EU28	Russia	US
2013	16.2	2.7	25.4
2014	13.5	9.4	13.0
2015	4.0	2.7	7.2
2016	10.4	1.8	7.5
2017	11.1	6.7	11.8

Source: fDimarkets.com

China's enthusiasm for investment in Russia is less evident in terms of acquiring companies. For most of the past six years, Russia has contributed less than 4 percent of China's overall outbound M&A. Furthermore, there were hardly any acquisitions in 2017 and 2018. Interestingly, though, 2019 has seen a huge rise in activity because of a very large transaction, namely China National Petroleum Corporation and China National Offshore Oil Corporation's acquisition of a 20 percent share of Novatek's Arctic LNG 2. This deal alone amounted to 16.7 percent of China's total outbound M&A in the first half of 2019 (Figure 12 and Table 2). Because of China's sharp increase in oil imports from Russia, it confirms that China is viewing Russia as an important strategic partner (Wittman, 2019).

Figure 12: Chinese M&A in Russia



Source: Bruegel based on Mergermarket and American Enterprise

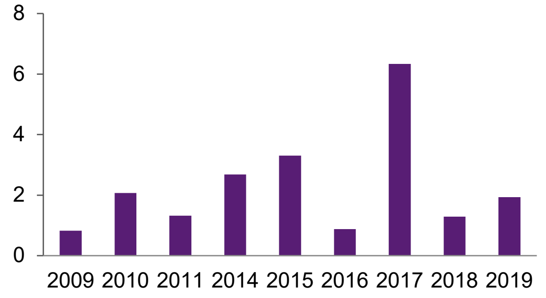
Table 2: Share of China's completed M&As (by deal value, %)

Year	EU28	Russia	US
2013	7.7	3.3	34.1
2014	47.5	3.8	12.0
2015	40.8	0.1	17.4
2016	33.0	1.1	32.7
2017	25.6	0.7	21.8
2018	47.4	0.0	5.9
2019 H1	42.8	16.7	11.7

Source: Bruegel based on Mergermarket and American Enterprise Institute.

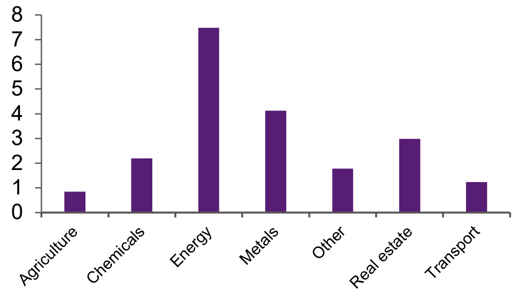
In terms of lending, especially project finance, China has rapidly become more influential in Russia. According to American Enterprise Institute statistics, there were hardly any Russian projects financed by China before 2009, but such activities accelerated thereafter and peaked in 2017, with $6.34 billion in projects built and financed by China. Russia now accounts for more than 6 percent of China's total external project finance value – a share much higher than Russia's trade share (Figure 13). Since the peak year of 2017, however, Chinese project finance in Russia has moderated. The key sectors for lending reflect China's comparative advantage, namely raw materials (including chemicals, metals and energy), and also China's expertise, with project finance also covering infrastructure and real estate (Figure 14).

Figure 13: Chinese project finance in Russia ($bns)



Source: American Enterprice Institute.

Figure 14: Industry breakdown of Chinese project finance ($bn)



Source: American Enterprise Institute.

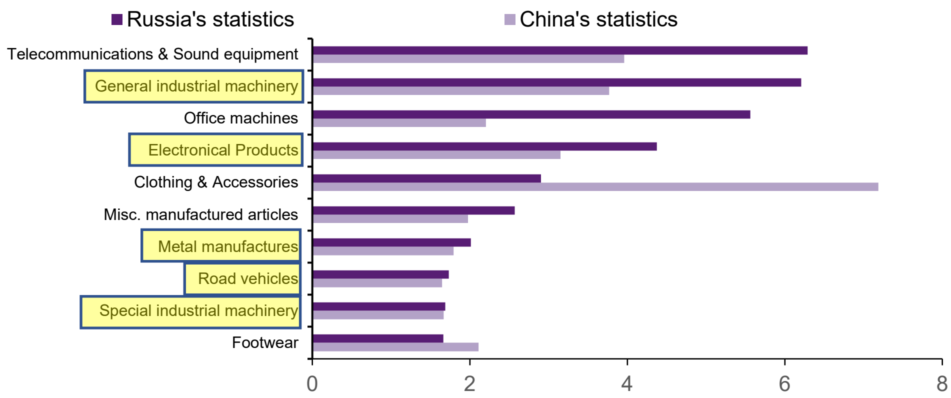
3 To what extent do China and the EU compete on the Russian market?

For trade: increasingly

The surge in Chinese trade with Russia clearly poses challenges for European firms. In 1995, the EU accounted for 40 percent of Russia's total imports and that share went up to 53 percent in 2002 and down again more recently to about the level it started at in 1995, namely 40 percent. However, China's share of Russia's imports has increased steadily from less than 3 percent to 21 percent.

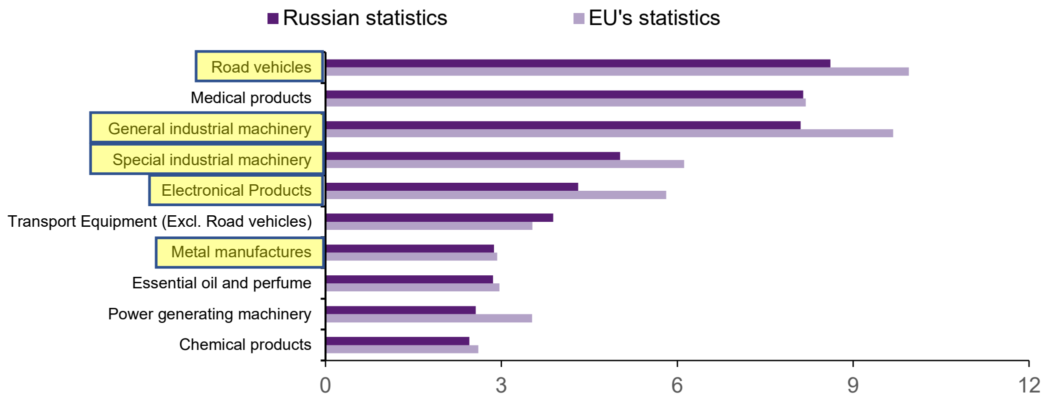
In terms of sectors, half of the Chinese and EU top 10 most-exported goods to Russia overlap, including electrical products, general and special machinery and road vehicles (Figures 15 and 16). According to Russia's own statistics, the total value of the five overlapping groups of products imported from China reached $16.01 billion in 2017, already more than half of the equivalent imports from the EU28 ($28.92 billion). Another important example is telecommunications and sound equipment, which is China's top exported product category to Russia but is missing from the EU's top 10 list of exports to Russia.

Figure 15: China's exports to Russia (2017, $bns)



Source: Bruegel based on Natixis, UN Comtrade at the SITC2 Rev.3 classification.

Figure 16: EU's exports to Russia (2017, $bns)

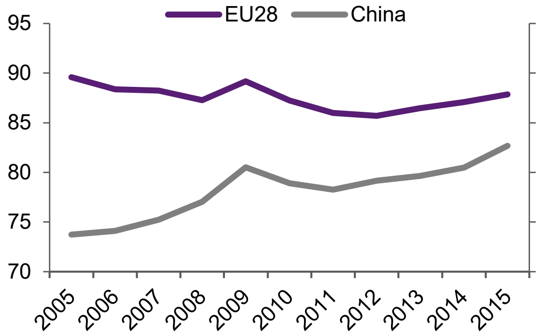


Source: Bruegel based on Natixis, UN Comtrade at the SITC2 Rev.3 classification.

García-Herrero and Xu (2016) confirmed quantitatively that Chinese exports are increasingly relevant substitutes for EU exports on the Russian market, especially in capital-intensive sectors such as electronic products. That said, China's export growth over the past two decades has concentrated on the processing trade, or the business activity of importing parts and components from abroad for processing or assembly, with the finished goods re-exported to the rest of the world. However, China has been moving up the ladder by incorporating a larger share of domestic production in the final goods its exports (Figure 17). This is also true for China's exports to Russia, with average domestic value added increasing from slightly above 75 percent to over 80 percent from 2005 to 2015. Meanwhile, the domestic value added of EU exports to Russia is still higher than China's, but has remained stagnant since 2005 and more recently has even dropped[2] (Figure 18). This evidence suggests that an increase in China-Russia economic cooperation could have a negative impact on European exports, which is confirmed by the simulation exercise carried out by García-Herrero and Xu (2016).

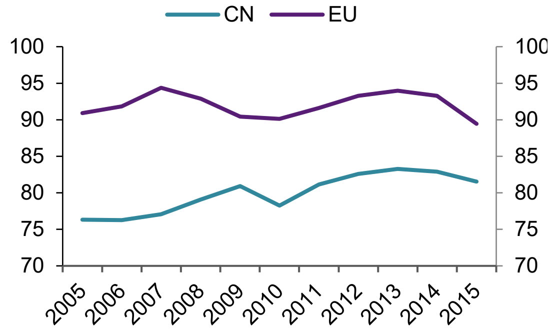
[2] Our report of domestic value added in exports for the EU treats intra-European trade as domestic based on the data from OECD (TIVA).

Figure 17: Domestic value added in gross exports to world (%)



Source: Bruegel based on Natixis, OECD Tiva.

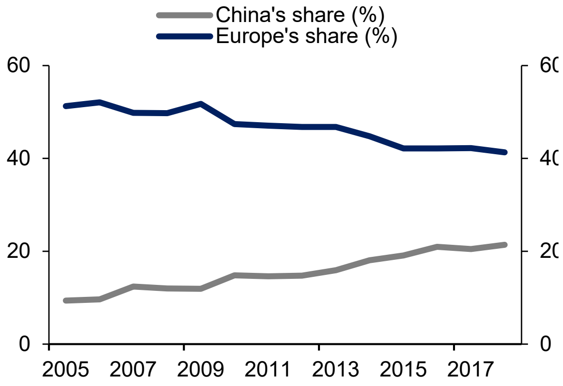
Figure 18: Domestic value-added embedded in China and EU gross exports to Russia (%)



Source: Bruegel based on OECD Tiva.

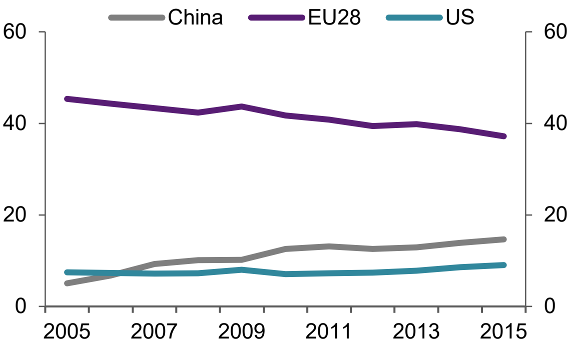
All in all, the increase in China's market share in Russia that we find when looking at gross trade data (Figure 19) is confirmed when controlling for the value added of European versus Chinese exports (Figure 20). This is in line with our finding that the domestic share of China's value-added exports to Russia has increased very steadily (Figure 17), and is also in line with the changes in the top 10 Chinese products exported to Russia.

Figure 19: EU28 & Chinese market shares in Russia



Source: Bruegel based on Natixis, UNCTAD.

Figure 20: Share of the value-added embedded in Russia's final demand (%)



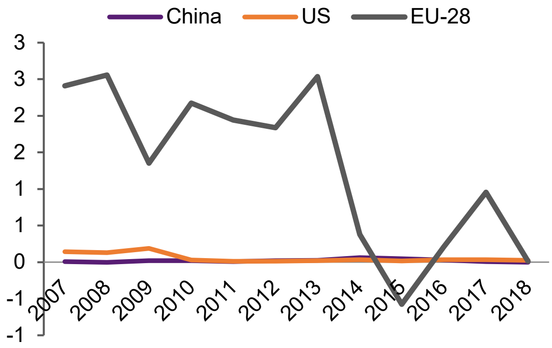
Source: Bruegel based on OECD

Not much competition for investment

China-EU competition in the field of investment is much less pronounced. As section 2 showed, while Chinese investment in the world has surged, its exposure in Russia is limited and remains much less than the EU's. For example, the Chinese FDI flow into Russia was only $140 million in 2017 (less than 0.01 percent of Russia's GDP), and the value even dropped into negative territory, to $-13 million, in 2018. Meanwhile, the EU28 total FDI flow into Russia reached $2.7 billion and $15 billion in 2016 and 2017, accounting for 0.21 percent and 0.95 percent of Russia's GDP respectively (Figure 21).

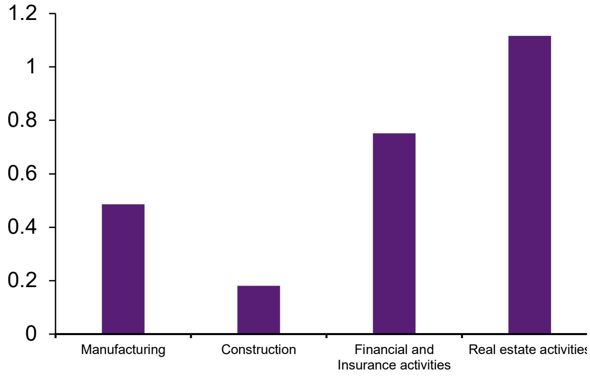
In addition, the industry focus of Chinese investment has been very different to that of the EU28. In 2018, the biggest target of Chinese direct investment in Russia was the real-estate sector, with the financial and manufacturing sectors attracting less Chinese investment. EU companies have much broader interests in manufacturing and a number of service sectors including wholesale and retail (Figure 22).

Figure 21:
FDI flow into Russia



Source: Bank of Russia

Figure 22: Industry breakdown of the EU's FDI position in Russia ($bns, 2018)



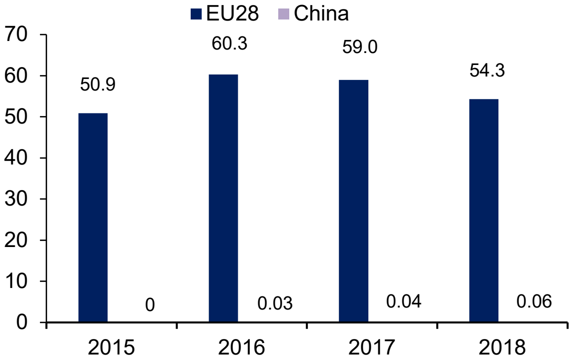
Source: Bank of Russia.
Note: only sectors with FDI larger than 0.1 billion are reported.

Financial competition is starting

Following the annexation of Crimea by Russia, the financial role the EU played in Russia was taken over by China because of the enforcement of sanctions by Western countries in 2014. Indeed, there was a sharp decline in the EU's financial claims in Russia in 2016, only two years after the sanctions were imposed. In the meantime, China has continued to support projects developed in Russia, as shown by the steady increase in Chinese project finance.

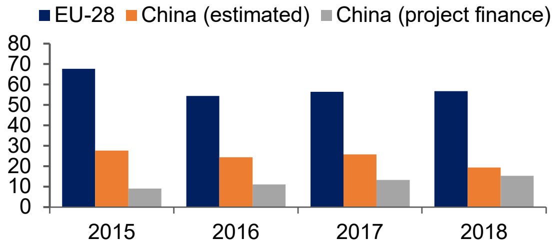
While the trend is clear, the EU still has a much greater financial exposure than China in Russia. First, EU portfolio investment in Russia is clearly larger than Chinese portfolio investment. As for bank lending, while there are no official statistics on the role of Chinese banks as cross-border lenders, an upper limit (including all the undisclosed countries in the Bank for International Settlements cross-border lending statistics) indicates that China could be equal to as much as one-third of the EU's lending position in Russia (Figure 23). Chinese project finance, while increasing, still does not equal even one third of the EU's lending flows into Russia. In fact, according to the American Enterprise Institute, the cumulative value of Chinese project finance in Russia since 2005 was $18.7 billion in 2018. For the EU countries, total cross-border lending for the 14 largest EU countries shows accumulated claims in Russia of about $57 billion in 2018 (Figure 24). EU project finance data was unfortunately not available to us.

Figure 23: Portfolio investment assets (sum of equity and debt) of Russia ($bns)



Source: Bank of International Settlement.

Figure 24: Comparison of EU and Chinese lending position to Russia ($bns)



Source: Bruegel based on cross-border lending data from Bank of International Settlement, and project data from the construction projects collected by the American Enterprise Institute.
Note: Cross-border lending data was estimated as the difference between Russia's total liabilities minus the available BIS reporting country's lending to Russia .

4 Conclusions

We have reviewed China's growing economic influence in Russia and compared it with that of Europe for the key aspects of economic relations, namely trade, investment and lending. It seems clear that Europe remains Russia's largest trading partner, lender and investor, but China is catching up quickly, especially on trade and project finance. However, Chinese investment in Russia remains limited, especially in terms of acquisitions. Chinese greenfield investment is much more notable. Furthermore, China's 2019 acquisition of a stake in one of Russia's most strategic companies, Novotek, seems to indicate that Russia is becoming a major strategic partner for China.

Competition between the EU and China on the Russian market shows up most clearly in trade data, with the EU losing market share and China ramping up the value added of its exports to Russia. This is much less the case for investment and is only starting for cross-border lending, mainly in the project finance field.

Finally, and more specifically on trade competition, our estimates of the increased share of Chinese value-added going into Russia, with a stagnant share for Europe, confirms our earlier empirical findings based on industry level data in García-Herrero and Xu (2016).

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Annex:

Table A1: Chinese/EU competition in Russia, 1996 to 2018

			1996 to 2000 *Annual average*	China's accession to WTO — 2001 to 2014 *Annual average*	Western's sanction on Russia — 2015 to 2018 *Annual average* → Time
China	Export	To the world:	192.4 Billion	1234.5 Billion	2280.4 Billion
		To Russia	1.9 Billion **(1.0% of total)**	24.7 Billion **(2.0% of total)**	40.6 Billion **(1.8% of total)**
	Market share	In the world:	3.5%	9.6%	13.8%
		In Russia	3.3%	13.2%	20.6%
	Trade balance	To the world:	29.9 Billion	168.4 Billion	468.6 Billion
		To Russia	-2.7 Billion	1.2 Billion	-1.8 Billion
China's top-5 exported goods in Russia			- Clothing - Footwear - Meat - Misc. manufactured articles - Textile yarn, fabric	- Clothing - Telecommunication - Footwear - Electronic products - Textile yarn, fabric	- Clothing - General industrial machinery - Telecommunication - Electronic products - Footwear
EU-28	Export	To the world:	1702.3 Billion	1631.0 Billion	2085.3 Billion
		To Russia	25.3 Billion **(1.5% of total)**	100.4 Billion **(6.16% of total)**	89.3 Billion **(4.3% of total)**
	Market share	In the world:	31.2%	12.6%	13.0%
		In Russia	48.8%	48.6%	41.9%
	Trade balance	To the world:	-135.0 Billion	-147.6 Billion	24.3 Billion
		To Russia	-15.9 Billion	-74.4 Billion	-56.1 Billion
EU's Top-5 exported goods in Russia			- General industrial machinery - Electronic products - Road vehicles - Special industrial machinery - Meat	- Road vehicles - General industrial machinery - Special industrial machinery - Electronic products - Medical products	- Road vehicles - General industrial machinery - Medical products - Special industrial machinery - Electronic products -
Oil price (Brent Generic 1st Future)			$20.1	$70.5	$56.9

Note: China (1996 to 2017) and EU (1996-2018) Trade data is sourced from UN COMTRADE, and China (2018) and the Russia data is sourced from UNCTAD Merchandise trade database.

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Bruegel, Rue de la Charité 33, B-1210 Brussels
(+32) 2 227 4210
info@bruegel.org
www.bruegel.org