


The Russia-Ukraine Conflict and the Chinese Economy



Alicia Garcia Herrero – Chief Economist Asia Pacific
+852 3900-8680 – alicia.garciaherrero@natixis.com

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PRELIMINARY THOUGHTS

ECONOMIC RELEVANCE OF RUSSIA'S MILITARY CONFLICT IN UKRAINE

- China affected through different channels: a key one is oil prices, as well as scarcity of commodities more generally
- There is also a financial channel as Chinese banks are exposed to Russia
- Economic/financial sanctions from the West also having a bearing on China through different channels
- Beyond sanctions, Western companies' voluntary actions on Russia also relevant for China
- China's position regarding the War in Ukraine also key to understand economic impact



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WHERE DOES THE CHINESE ECONOMY STAND

Government Work Report growth target does not seem to be followed with enough fiscal and monetary measures

Growth
5.5%

- China is betting on cushioning the cyclical deceleration with a strong growth target set for 2022 (5.5%).

Fiscal Deficit
2.8% of GDP

- It is smaller than that of 2021 (3.2%). But the surplus profits from designated state-owned financial institutions and state monopoly business operations will be transferred to support government expenditure, amounting to an additional 1-2% of GDP.

Transfer to Local Government
9.8 trillion

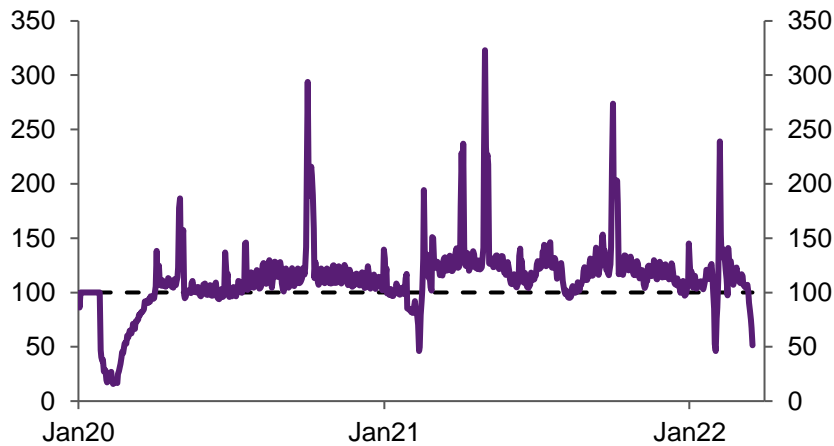
- It is up from 8.2 trillion in 2021. This is on top of the quota set for the local governments' issuance of special purpose bonds which is the same as that for last year.

Monetary Policy
Robust Support for Real Economy

- Premier Li has also encouraged financial institutions to pass the PBoC's easing to their clients through lower interest rates and fees.

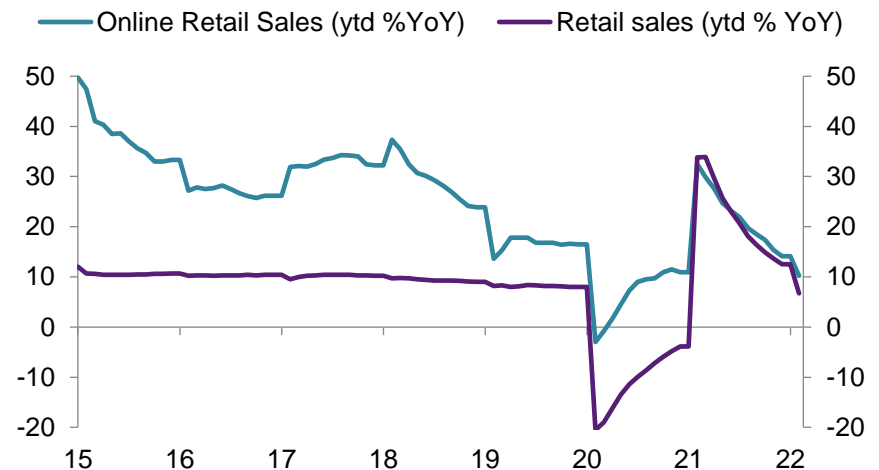
Omicron outbreak has already reduced China's mobility quite substantially, getting close to that of early 2020 during the first Covid outbreak. Consumption growth has been poor recently, even for online sales and this sharp drop in mobility will not help

China: Mobility Index (Jan-2020=100)



N.B. Data as of Mar 17, 2022. Index calculated based on weighted average of daily traffic into and out of prefectures. The first 5 weeks of 2020 are used as baseline.
Source: Natixis, CEIC

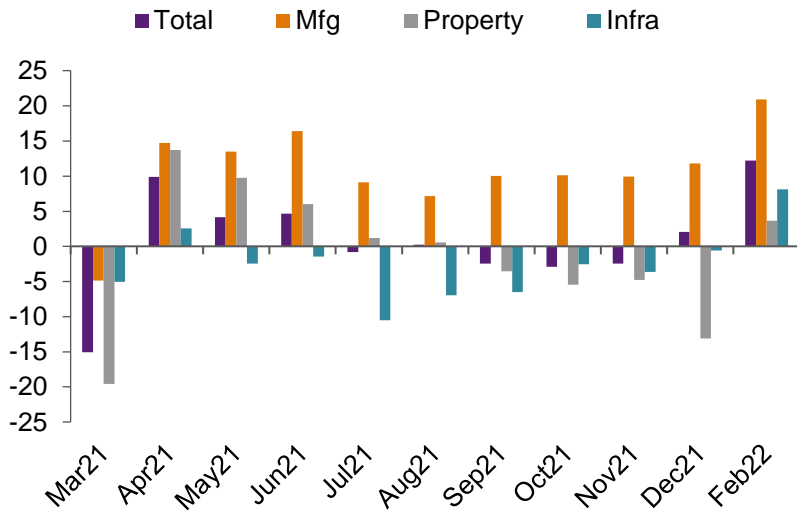
Retail Sales and Online Retail Sales



Sources : NBS, Natixis

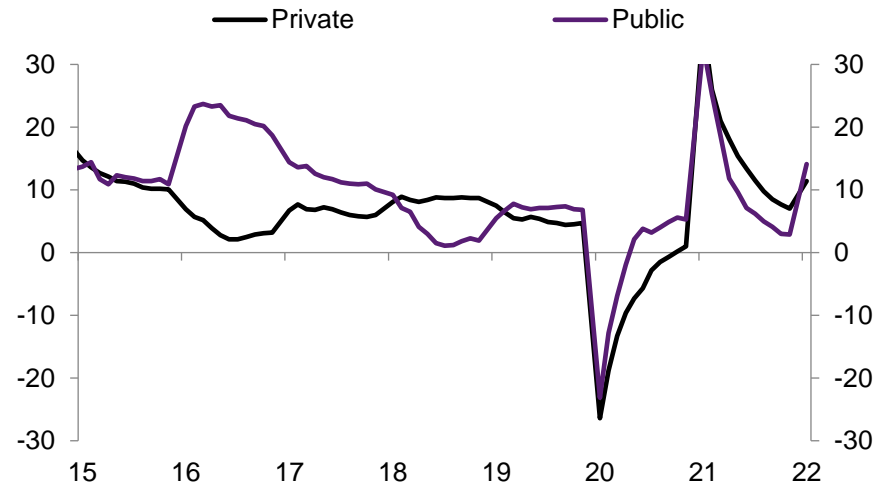
Incoming data much better than expected for fixed asset investment, still dominated by manufacturing sector

China's Investment Breakdown (% YoY)



Source: Natixis, CEIC

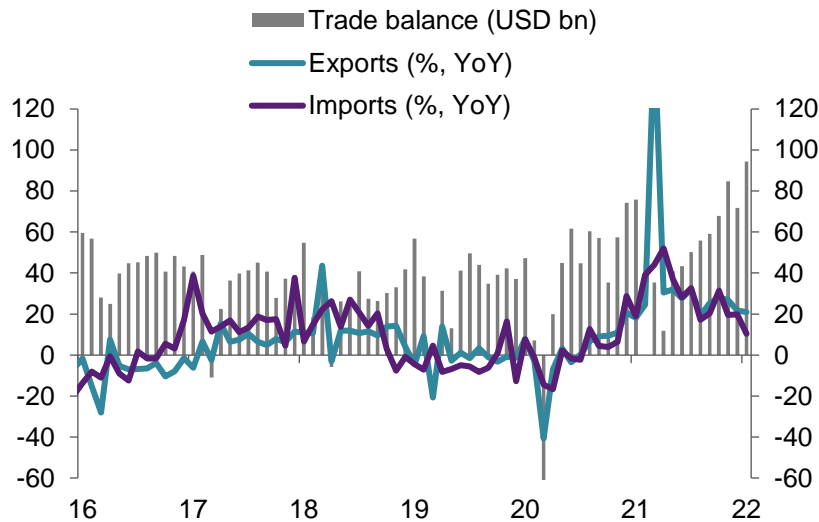
China Fixed Asset Investment (% YoY)



Source: Natixis, Bloomberg

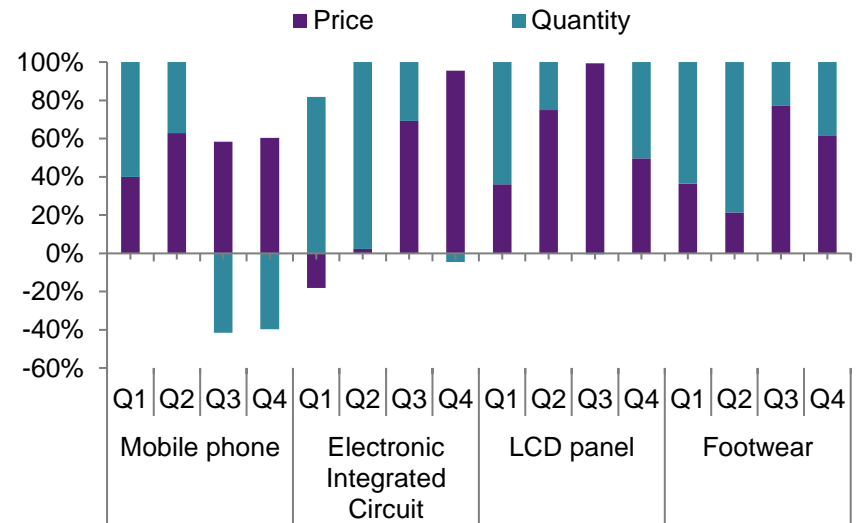
Exports momentum subdued since the beginning of 2022. This is already the case since 2021 if we consider how much price increases have been behind the export boom (rather than volume)

China's Trade in Goods



Source: Natixis, Bloomberg

Main export products growth contribution 2021



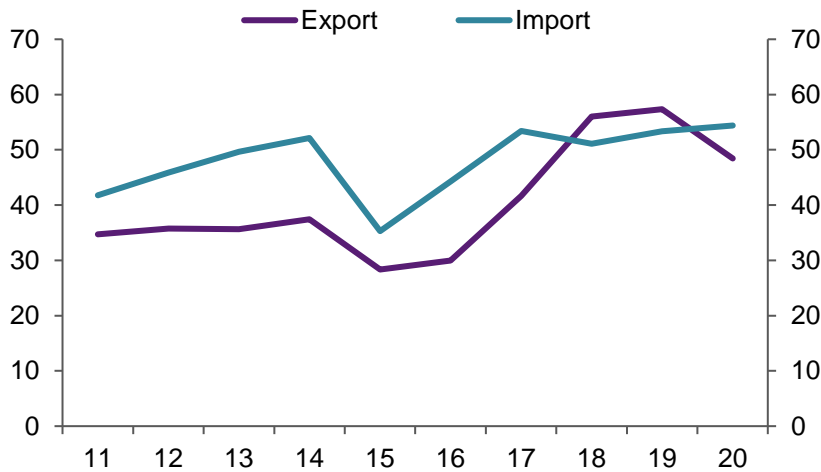
Source: Natixis, CEIC



POTENTIAL IMPACT OF THE WAR IN UKRAINE

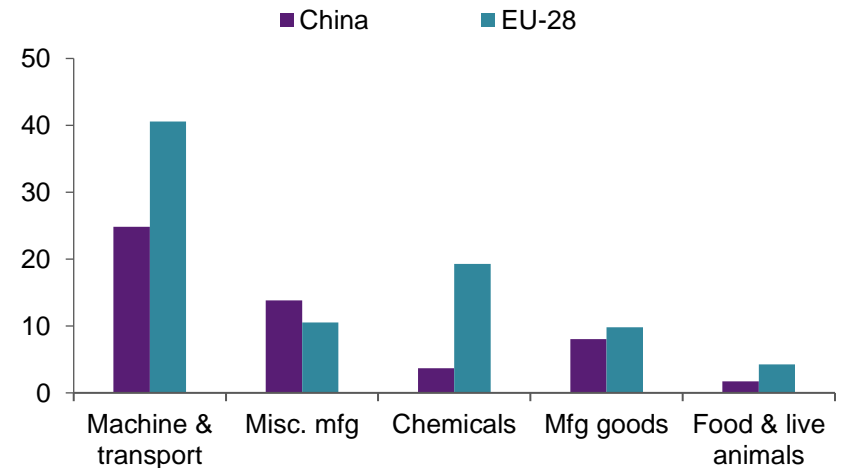
The immediate impact through the trade channels is the soaring energy price, but China's regulated electricity prices could cushion the short-term impact. Over longer term, the strategical relationship between China and Russia as regards energy and other resources is key. Russia is bound to continue to substitute imports away from the EU for Chinese ones

Russia's Exports and Imports with China (USDbn)



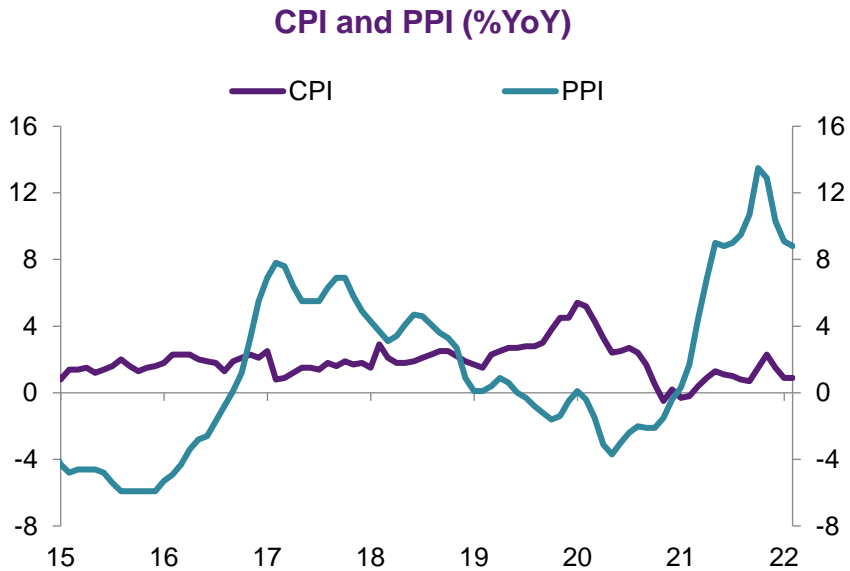
Source: Natixis, UNCTAD

Russia's Imports from China and the EU (2019, USDmn)

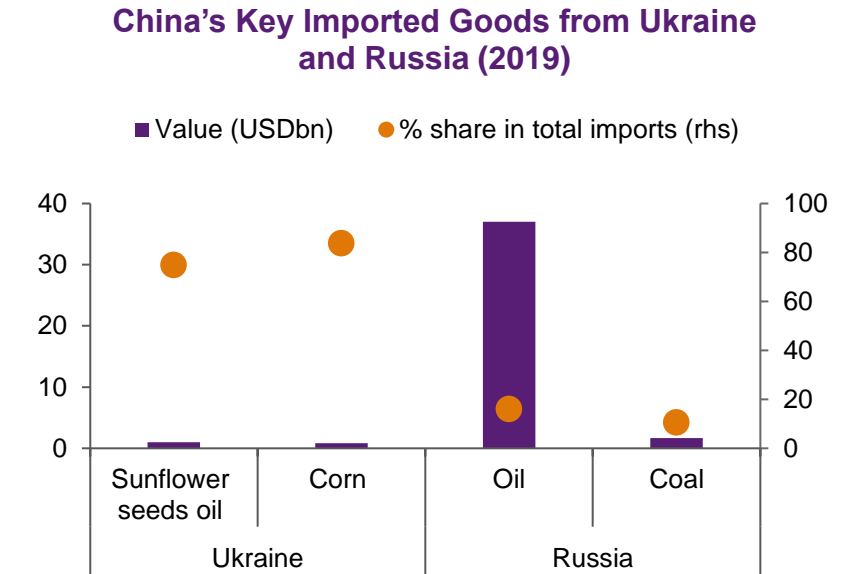


Source: Natixis, UNCTAD

The Ukraine crisis may also affect certain food product which China relies on Ukraine, but these products comprise a very small proportion, so the macroeconomic impact is limited, all the more so given China's recently low CPI inflation



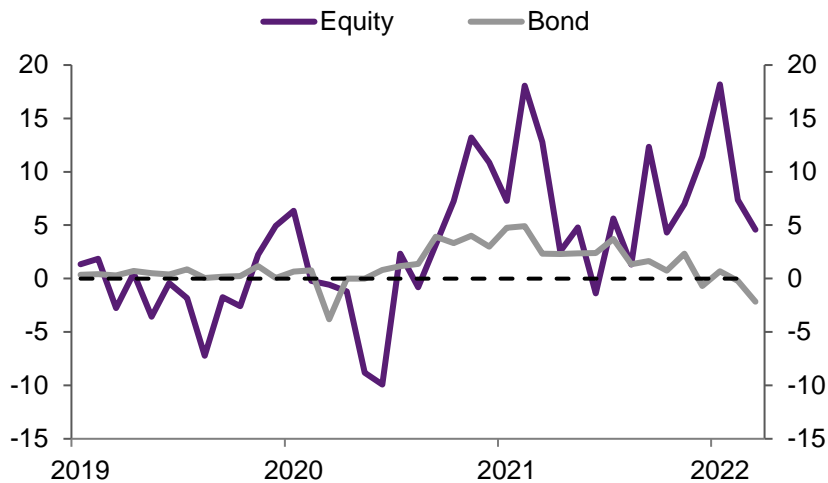
Source: Natixis, Bloomberg



Source: Natixis, UNCTAD

China seems like a safe haven when Russia started its invasion of Ukraine but the situation changed radically in the second week of March with massive outflows, especially from the fixed income market. The RMB has since weakened slightly

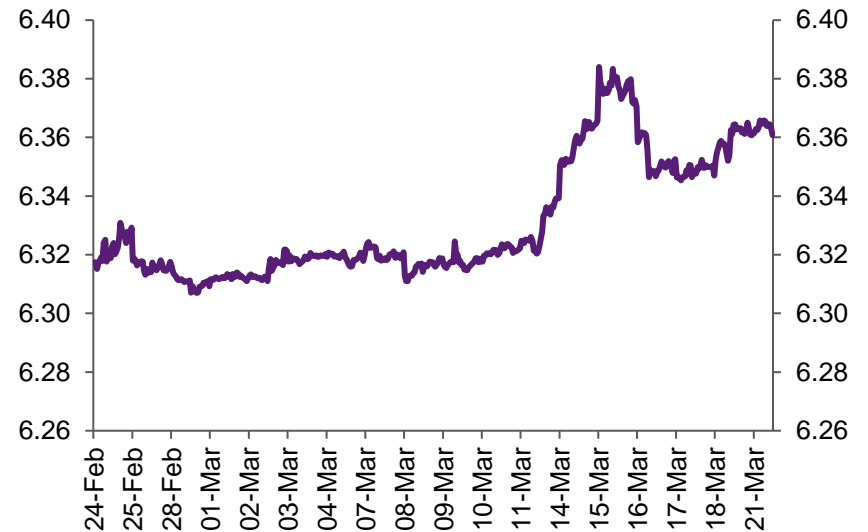
China Capital Inflow (USD bn)



N.B. Data as of Mar 18, 2022.

Source: Natixis, EPFR

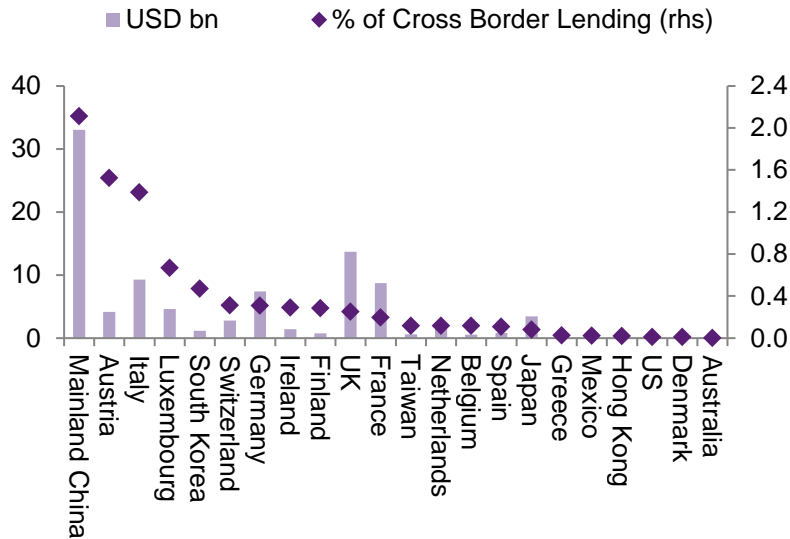
USDCNY



Source: Bloomberg, Natixis

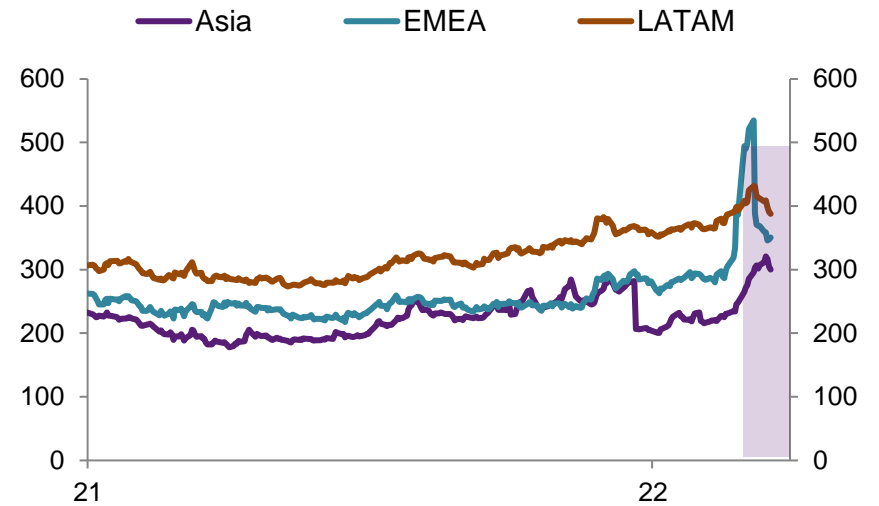
For cross-border lending to credit spreads, the spillover from Russia into Asia's financial sector is limited

Cross-border Lending to Russian Entities



N.B. Data as of 2021 Q3. *Estimated value.
Source: Natixis, Bank of International Settlements

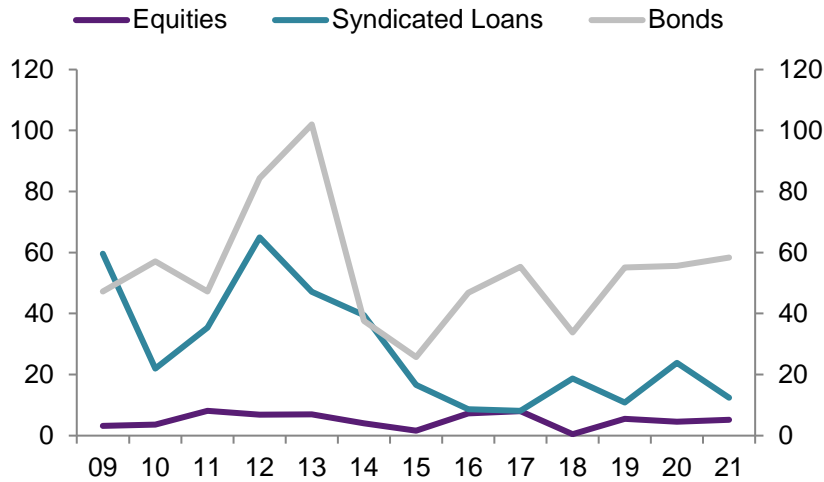
Credit Spread of USD Bonds (bps)



N.B. Data as of 18th March 2022. Benchmark as the yield of US treasuries based on the respectively weighted maturity.
Source: Natixis, Bloomberg

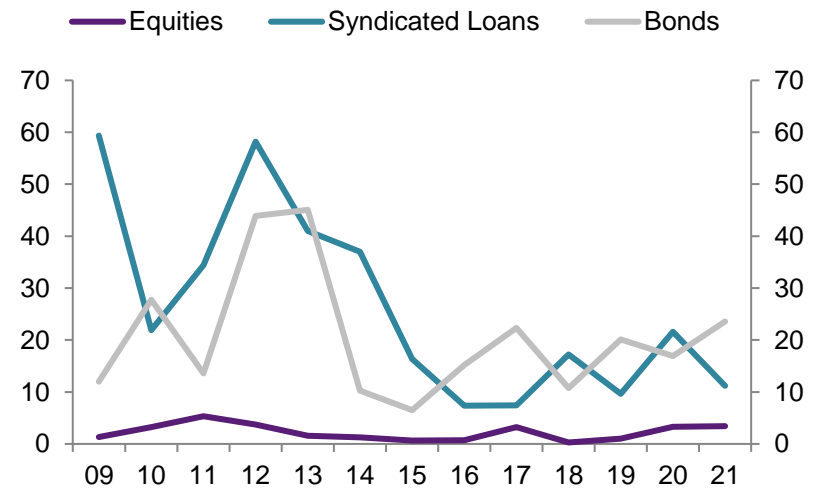
Since the annexation of Crimea in 2014, Russian entities are in a more difficult financing situation, especially in hard currencies

Capital Raised by Russian Entities in All Currencies (USD bn)



N.B. Equities include initial public offerings, additional share offerings and right offerings.
Source: Natixis, Bloomberg

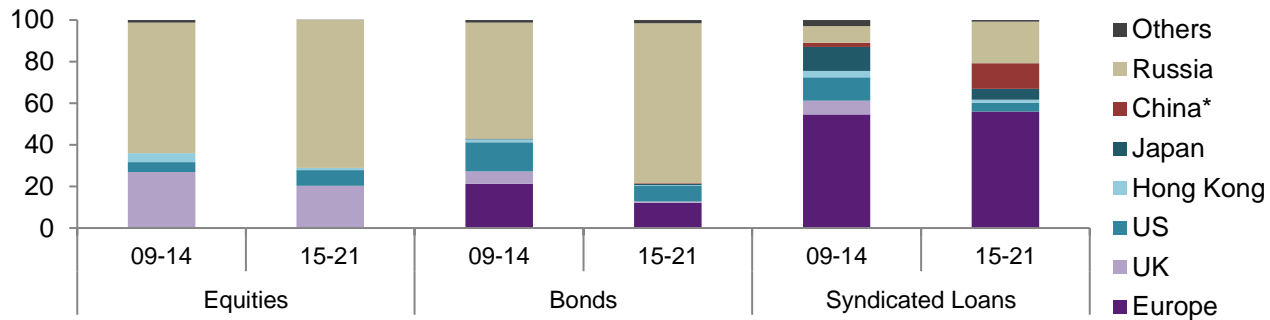
Capital Raised by Russian Entities in Hard Currencies (USD bn)



N.B. Equities include initial public offerings, additional share offerings and right offerings.
Source: Natixis, Bloomberg

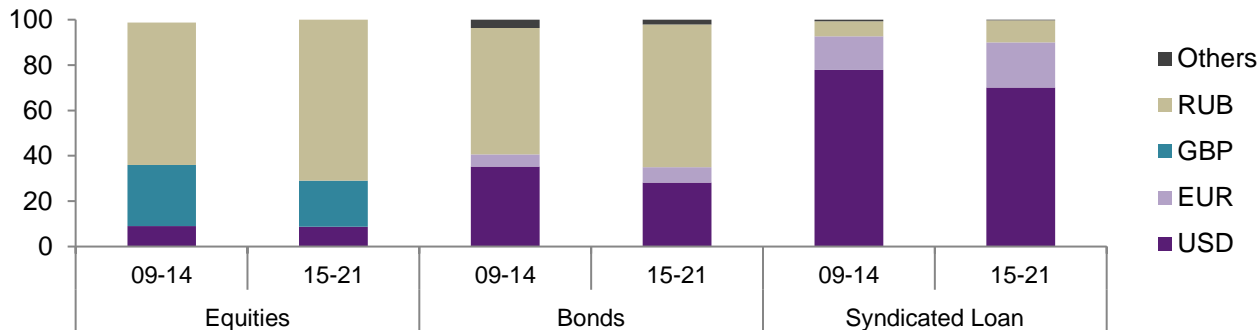
China's relevance for Russian companies' financing remains limited and so is the use of RMB as funding currency

Capital Raised by Russian Entities by Lenders/Investors (%)



* Include Mainland China for statistical purpose
 N.B. Including all currencies. Equities include initial public offerings, additional share offerings and right offerings. Syndicated loans classified by the origin of banks. Source: Natixis, Bloomberg

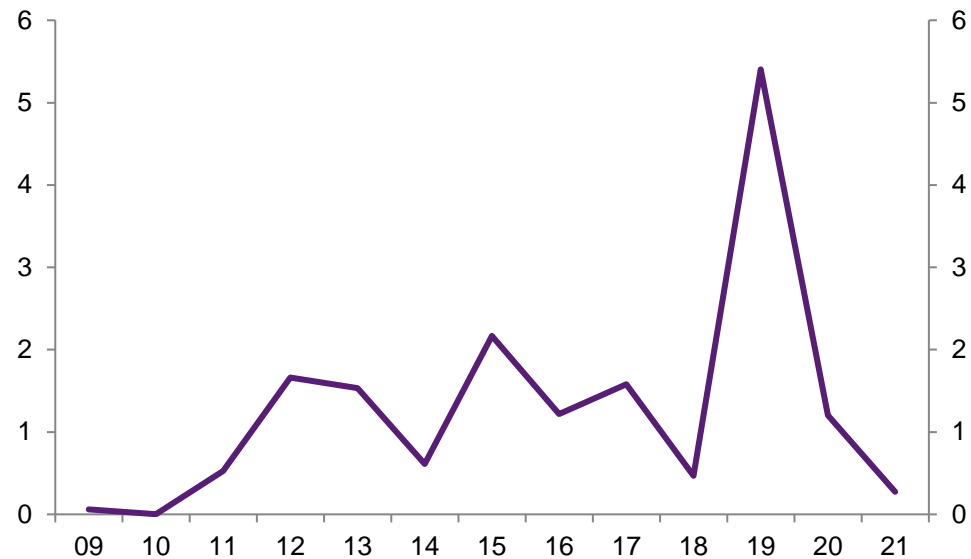
Capital Raised by Russian Entities by Currency (%)



N.B. Including all currencies. Equities include initial public offerings, additional share offerings and right offerings. Source: Natixis, Bloomberg

China's loans towards Russia have shrunk aggressively since the pandemic started

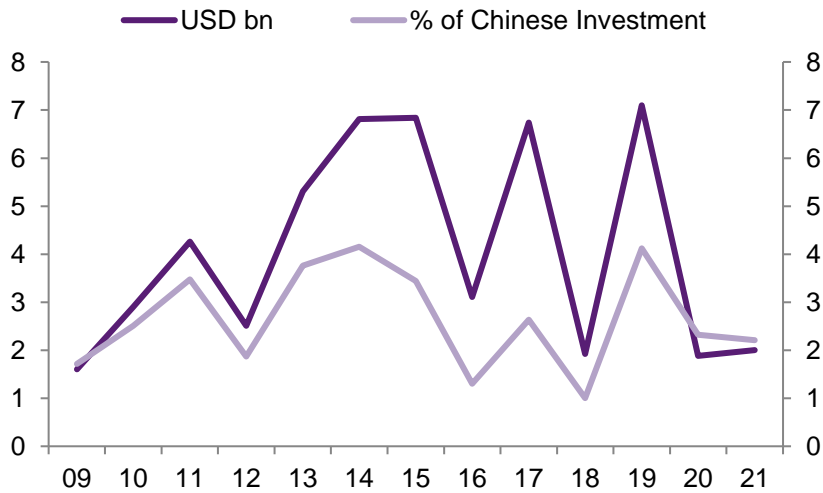
Syndicated Loans Raised by Russian Firms from China (USD bn)



N.B. Classified by the origin of banks.
Source: Natixis, Bloomberg

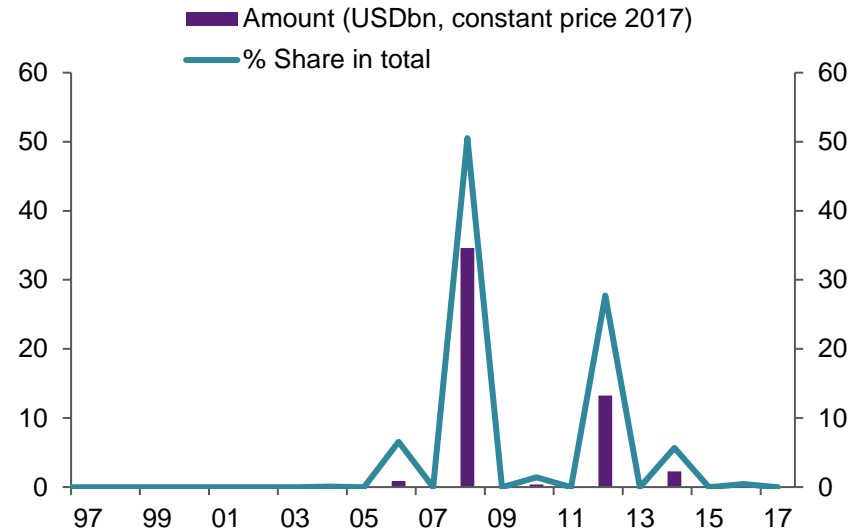
The same trend can be found for project finance and development finance

Project Finance in Russia by China



Source: Natixis, American Enterprise Institute

China's Development Finance to Russia



Source: AidData, Natixis



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**WILL CHINA HELP
RUSSIA AND, IF SO,
CAN IT DO IT?**

China's role in the Ukraine crisis depends on many factors

- The duration, depth, and potential expansion of Western sanctions and China's response
- The US-EU-China long-term economic relationship after the Ukraine crisis
- China's strategical relationship with Russia, especially as regards energy cooperation

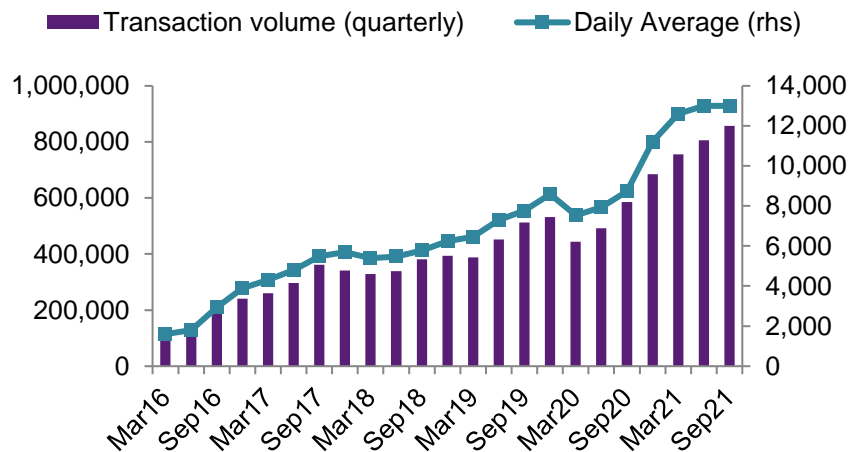
A valid question is, whether China will help Russia in the short run

- The most likely scenario is that China will abide to the “letter of the law” (Chinese banks no longer offering LCs for Russian operations) but not necessarily the “spirit of the law” (China increasing imports of wheats from Russia)
- The question is whether that will be enough for Russia at the current juncture since sanctions are clearly biting
 - Bans on exports of semiconductors quite important as they constraint Russia’s military capability
 - Is there scope for SMIC?
 - Trade in RMB not enough of a solution, particularly if secondary sanctions are imposed. CIPS still runs on SWIFT

China's financial infrastructure needs to evolve to offer a respite to Russia: not an immediate answer

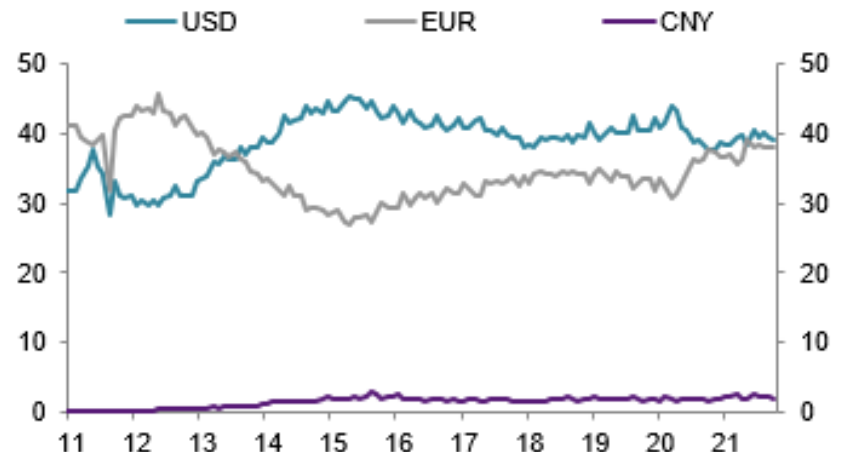
CIPS still underdeveloped even if it were to introduce its own messaging system: not enough counterparties or volume even if growing fast. As for the E-CNY, Russia might not be keen to have it circulating further weakening the ruble, all the more so being non-convertible

RMB Cross-border Interbank Payment System (transaction volume)



Source: PBoC

Share as International Payment Currency(%)

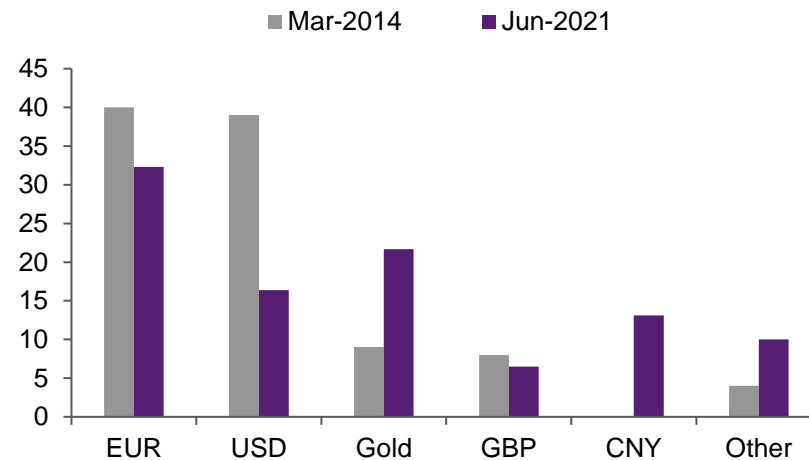


Source: Natixis, SWIFT, Bloomberg

One potential immediate line of help is the use of Russia's RMB reserves at the PBoC

But this might only be used to pay imports from China, not to serve debt or pay other imports. If PBoC were to convert RMB into USD, it would probably imply bypassing sanctions

Currency Composition of Russia's Reserve Assets (%)



Source: Natixis, Bank of Russia, IIF



CONCLUSIONS

Conclusions

- The Chinese economy is struggling so that the target in the Government Work Report will not be easy to reach.
- Big stimulus needed but somehow not really coming, notwithstanding Liu He's "Whatever it Takes Pitch"
- China's economy and financial sector affected by Ukraine but not the biggest problem
- As regards China's potential help to Russia, the medium-run seems clearer: closer economic relations with energy and military cooperation as potentially key
- However, in the short run, China will need to walk a fine line to avoid sanctions but trying to support Russia without worsening the relations with the West. The three together being close to the impossible Trinity!

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