China’s Tight Balancing Act On Russia-Ukraine Crisis

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As Western economies deepen sanctions on Russia, China has avoided the pressure to take sides. We expect China to walk a tightrope to limit the impact on its own national interests. Despite stronger ties between Beijing and Moscow in recent years, there are limits to China’s friendship. Yet, amidst recent bouts of volatility, the yuan has been very resilient. As the “greenback” (US dollar) becomes more weaponized, the lure of the yuan as an alternative reserve currency is rising.

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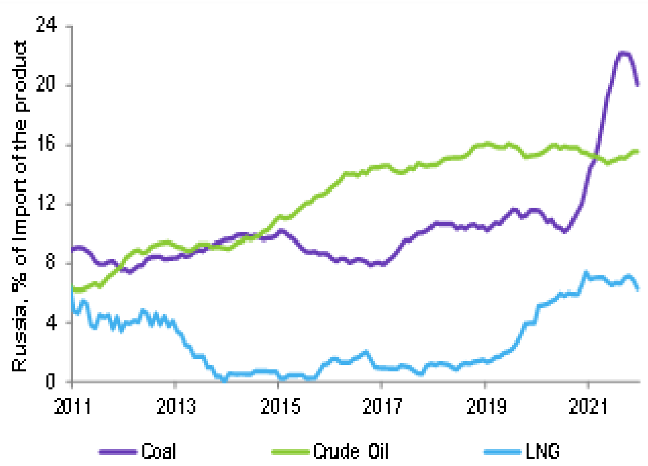
- Rising share of Russia in China’s imports of energy commodities
- Despite stronger ties between Beijing and Moscow in recent years, there are limits to China’s friendship
- The yuan has been very resilient amidst recent bouts of volatility
- Meanwhile, the lure of the yuan as an alternative reserve currency is rising

Chart 1: Rising share of Russia in China’s imports of energy commodities



Source: CEIC, SEB

As Western economies deepen sanctions on Russia, China has avoided the pressure to take sides

On 25 February, a day after the military conflict between Russia and Ukraine spread to Ukraine’s major cities, Chinese President Xi Jinping held talks with Russian President Vladimir Putin.

By advocating for peaceful negotiations between Russia and Ukraine, China is signifying its discomfort over Russia’s military actions. Moreover, China has reiterated that it respects the “sovereignty and territorial integrity of all countries.” Even so, Beijing has refrained from calling Russia’s actions as an “invasion.” It was no surprise when China abstained to vote on a UN Security Council resolution that would have deplored Russia’s aggression against Ukraine.

By 1 March, China’s Foreign Minister Wang Yi fielded a call with his Ukrainian counterparty Dmytro Kuleba. Although China seems to be warming up to the idea of brokering a ceasefire, it has not indicated an intention to take direct action against Moscow. Historically, Beijing has opposed unilateral actions like sanctions against nations. It has been consistent in its view that sanctions are not effective in solving issues.

China will walk a tightrope to limit the impact on its own national interests. So far, China has maintained its strategy of non-interference and has kept trading links with Russia open.

Rising share of Russia in China's imports of energy commodities

Although Russia accounts for only 2.9% of China's total imports, Russia stepped up to the plate in 2021 when China faced an energy crunch.

As a result, Russia now accounts for over 20% of China's total coal imports (see Chart 1 above).

Moreover, Russia's share of China's imported crude oil has steadily risen to 15.6% by end-2021 from 11% in 2014.

While its share of liquid natural gas imports is comparatively modest at 6.3%, the two countries recently inked a 30-year contract for Russia to supply gas to China through its new Far Eastern pipeline.

This is the second long-term pipeline contract between Russia and China following the Power of Siberia-1 pipeline which began pumping supplies in 2019. When Gazprom and China National Petroleum Corporation (CNPC) signed the deal in early February, it was reported that the contract would be settled in euros to diversify the payment from the greenback.

Despite stronger ties between Beijing and Moscow in recent years, there are limits to China's friendship

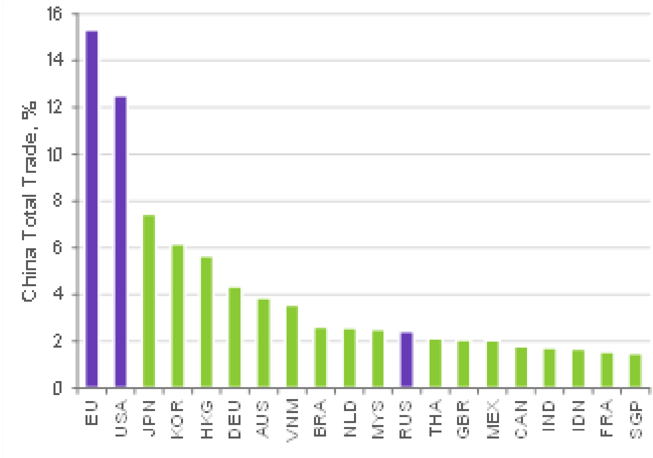
While Russia is an increasingly important source of energy, its total trade with China pales in comparison with China's trade links with the European Union and the United States. Among China's top trading partners, the EU accounts for 15.3% of China's total trade, followed by the US with 12.5% (see Chart 2 on the top right).

As sanctions against Russia mount, there are reports that some of China's largest state-owned banks are already limiting financing for transactions of Russian commodities.

Although sanctions have so far stopped short of Russia's energy trading, Chinese banks may have already stopped issuing USD-denominated letters of credit related to Russian commodities. Even so, CNY-denominated financing for Russian commodities may still be available, albeit with a higher level of scrutiny. Large Chinese banks would be reluctant to lose access to dollar transactions, in our view.

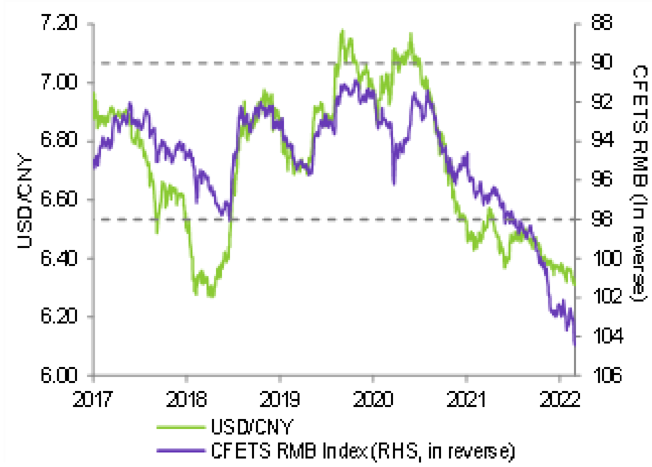
In the past, China's big 4 banks have complied with US sanctions against Iran and North Korea in a bid to maintain access to the dollar clearing system.

Chart 2: The EU is China's top trading partner



Source: CEIC, Bloomberg, SEB

Chart 3: RMB Index continues its uptrend



Source: Bloomberg, SEB

The yuan has been very resilient amidst recent bouts of volatility

The trade-weighted RMB index has tested the air above 105, the highest on record. Although the People's Bank of China (PBoC) is somewhat slowing the rise in the yuan onshore, the central bank is not putting up much resistance against a strong currency. The wider trade surplus since the start of the pandemic is still providing a substantial buffer in the current risk-off environment.

Aside from expectations of further easing by the PBoC, China's government bonds are also benefitting from safe-haven demand. The China-US 2year spread has narrowed further to beomce tighter than pre-pandemic spreads.

Meanwhile, the lure of the yuan as an alternative reserve currency is rising

As the USD becomes more weaponised, there is an incentive to convert more foreign exchange (FX) reserves into yuan.

As financial sanctions increasingly isolate Russia from global payment systems, its policymakers will likely be forced to further reduce the role of the USD in its economy. In anticipation of further sanctions, even more of the Russia-China bilateral trade may be settled in the yuan.

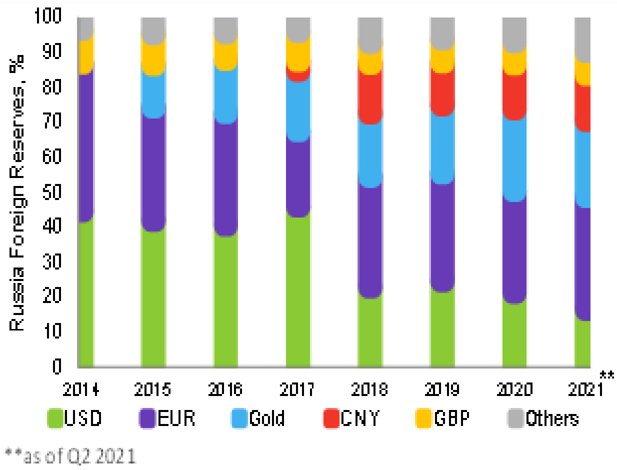
Earlier restrictions imposed following the annexation of Crimea in 2014 led to the diversification of Russia's foreign reserves away from USD (see Chart 4).

Of the USD 643 billion Russian foreign reserves, the share of USD has fallen to around 16% as of Q2 2021, from around 44% in 2014.

Similarly, the share of EUR has also declined to around 32% from around 42%.

Over the same period, Moscow turned to hoarding gold and other currencies. Gold now accounts for close to 22% of Russia's reserves, while cumulative purchases of almost

Chart 4: Rising share of CNY in Russia's Foreign Reserves



Source: Macrobond, SEB

USD 78 billion worth of yuan-denominated assets means that the yuan's current share is around 13%.

Overall, we expect favourable capital flows to keep the yuan resilient, as long as China manages to limit the economic impact of its decision to remain on the fence regarding the Russia-Ukraine crisis.

For now, we hold on to our year-end forecast for the USD/CNH currency pair at of 6.30.

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