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Russia's Dependence on China May Not Be Enough to Save Economy

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(Source: RBC News)

Executive Summary:

- Russia's increasing reliance on China for trade underscores potential vulnerabilities due to China's economic woes and the yuan's currency controls. This is prompting Russia to aggressively pursue the digital ruble.
 - Despite Western sanctions, Russia-China trade has increased, enhancing bilateral commerce and financial cooperation. Trade is also increasingly denominated in yuan and rubles, furthering the two countries' goals of de-dollarization.
 - Russia's economic growth relies heavily on state spending for military purposes, potentially leading to inflation and social unrest. The push for a digital ruble aims to manage these challenges, but highlights long-term economic vulnerabilities.
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On January 29, the Central Bank of Russia declared that it is in talks with BRICS member states about adopting “digital currencies” to facilitate international commerce. It emphasized the potential for integration of the digital ruble (CRDR) into the global economy with similar foreign currencies and usage in international trade. The CRDR, however, has yet to be launched properly. Banks and retailers are progressively joining a pilot program, bringing testing to millions of customers across regions (Crypto News (<https://cryptonews.com/news/russian-banking-association-launches-digital-assets-council.htm>), January 31). In August 2023, Anatoly Asakov, a member of the Russian State Duma, suggested that Russia might soon use the CRDR in its trade with China (TASS (<https://tass.ru/ekonomika/18517431>), August 15, 2023). Russia's rising reliance on China, however, might swiftly become an issue, given China's economic woes at home. Moscow is likely concerned about such developments because the yuan is not freely convertible because Beijing imposes controls on its value. The likelihood of a Chinese financial crisis, which was widely discussed in January, does not inspire confidence in Moscow (International Banker (<https://internationalbanker.com/finance/property-sectors-woes-could-weigh-heavily-on-chinas-2024-growth-prospects/>), January 18). This is likely one of the reasons Russia is aggressively pushing for a full launch of the CRDR.

When the West imposed sanctions on Russia, China filled the gap for many Russian imports. By the end of 2023, trade between Russia and China reached \$240 billion, marking a 26.3 percent increase compared to 2022, when it had reached a record high of \$190 billion in 2022, which was in turn a 29 percent increase from 2021 (General Administration of Customs of the People's Republic of China (<http://english.customs.gov.cn/statics/report/monthly.html>), accessed February 7). Russia stopped providing customs statistics in April 2022, but local reports have confirmed these numbers (Russian International Affairs Council (<https://russiancouncil.ru/en/analytics-and-comments/analytics/more-advanced-collaboration-expected-in-2024-china-russia-ties/>), January 6). While sufficient information is available on Russian energy exports to China and Chinese exports of cars, machinery, electronics, plastics, and alumina, which have critical military applications, little is said about their financial relationship.

The expansion in bilateral commerce has resulted in most trade being denominated in national currencies. The yuan's share in the Russian exchange and over-the-counter markets reached 46.2 percent and 31.5 percent, respectively, by November 2023 (Central Bank of the Russian Federation (https://cbr.ru/Collection/Collection/File/46675/ORFR_2023-11.pdf), November 2023). Chinese banks have also increased their assets in Russia, lending to Russian banks and companies with whom Western organizations to engage. Specifically, the “big four” state-owned banks in the People's Republic of China (PRC)—Industrial and Commercial Bank of China (ICBC), Bank of China, China Construction Bank, and Agricultural Bank of China—have boosted their assets in the country.

The presence of subsidiaries of these Chinese banks is due to a considerable increase in the customer base generated by Chinese firms entering the Russian market. They also serve as settlement banks in Russia for Chinese firms, government agencies, Russian companies, institutional customers, joint ventures, and multinational organizations. In addition, the Bank of China specializes in correspondent banking for Russian banks. Officially, these banks' initiatives are part of a larger effort to increase the use of the yuan in Russia rather than dollars and euros, allowing the Kremlin to pride itself on its essential contribution to the “de-dollarization” of international trade.

On January 31, Russia's largest security and banking organization established a “council” to self-regulate digital assets (Crypto News (<https://cryptonews.com/news/russian-banking-association-launches-digital-assets-council.htm>), January 31). On February 1, Russia's Central Bank stated that 17 additional institutions, including heavyweights such as Sberbank and Tinkoff, had joined the pilot (Crypto News (<https://cryptonews.com/news/group-of-17-russian-banks-officially-joins-second-stage-of-digital-ruble-pilot.htm>), February 1). The push for adopting the CRDR is not only to offer an alternative for the de-dollarization of international trade but also to manage Russia's growing socioeconomic problems. While Russia's economy defied all expectations in 2023, surpassing its 2021 levels, with GDP registering notable increases, it has done so because the Kremlin has used pretty much all resources to switch the national economy to a war economy. It is not the first time in recent history that Russia has used significant state stimulus to support the economy and prevent a social crisis. During the Covid pandemic, anti-crisis aid was 2.7 percent of GDP. In 2022–2023, however, it was substantially more. According to official Finance Ministry estimates, stimulus reached about 10 percent of GDP. Moreover, according to recent reports, the Kremlin has been using the liquid reserves in the national wealth fund to support the economy (Business Insider (<https://www.businessinsider.com/russia-economy-bleeding-money-liquid-reserves-national-wealth-fund-war-2024-1>), January 18).

While this does not mean Russia will run out of money in 2024, Moscow will soon have to deal with the repercussions of its policy. State spending has led to economic growth, which is set to continue in 2024. After all, state subsidies produce optimism, which supports the increase in demand. Industrial production, the manufacturing sector, and investment activity saw a boost due to the government's military spending. At the same time, Russia experienced an all-time

low unemployment rate in 2023, resulting mainly from draft-induced labor scarcity. This drove up nominal and real earnings, fueling consumption, GDP growth, and positive economic sentiment. For Russia to thrive, however, the Kremlin must sustain monetary supply.

Fears of growing inflation indicate that the economy may be overheating. This is already visible in the mortgage sector, where the expectation of increasing income has resulted in more borrowing. Mortgage subsidies are also contributing to a bubble which, considering the latest interview with the Central Bank head Elvira Nabiullina, seems to be a serious concern (Central Bank of the Russian Federation (<https://cbr.ru/press/event/?id=18375>), January 30). Scrapping or reforming mortgage subsidies would be an obvious solution, but it would go against the Kremlin's political goals, potentially cutting into the country's ability to sustain the war effort. The current subsidies program is aimed at IT specialists who keep the economy going independently of Western tech and, generally, Russia's middle class, which is now dominated by members of intelligence agencies, the military, and other state officials whose high pay is tied to the continuous war effort. Cutting down the benefits for the middle class would impact the war effort, something the government will not do.

The Central Bank needs more creativity in dealing with both hyperinflation and a potential Chinese financial crisis at a time when Russia's international trade is dependent on the Chinese currency. In theory, banks could be used to temper inflationary pressures, limiting internal consumption and Russian demand when needed. This, however, would not combat internal production problems. Due to labor shortages, Russian companies are already maximizing productivity by asking employees to take longer hours or extra shifts, which undercuts their standard of living even as wages increase. In other words, economic overheating could ultimately create social distress.

The CRDR constitutes a potential solution. Russia's 2024 budget, apart from highlighting the fact that Russia foresees a long war in Ukraine, indicates that the growing defense and social spending in the budget will be funded mainly by the steady depreciation of the ruble. This will eventually need to be controlled. With the digital ruble, the government is looking to acquire more control over the economy. Monetary control, however, has a limit, which is determined by the population's willingness to accept it.

Even if it is not apparent right now and even if Russia's resilience is high, the Kremlin is trapping society (and itself) by focusing only on military spending. Apart from Russia's growing dependency on China posing a systemic risk with potential immediate repercussions, this strategy also creates a long-term problem. On the one hand, it will become increasingly difficult for the state to continue funding the conflict in Ukraine without causing living standards to worsen. This would work against any form of control the government might currently have. On the other hand, reducing military spending will almost certainly result in a substantial structural shock that will take a long time to recover from, simply because the Russian economy is currently shrinking to sustain the war effort. Regardless, while regular Russians will bear the consequences, it may be that at the end of the war, not only will Ukraine's economic reconstruction need support, but so too will Russia's.

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