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CHAPTER 5

Russia's Economy and Development of the Far East

SUGANO TETSUO

On April 18, 1998, Russian President Boris Yeltsin and Japanese Prime Minister Hashimoto Ryūtarō met at Kawana, Japan, for their second "no-necktie" summit. Most of their time was spent reviewing the terms of the Hashimoto-Yeltsin Plan, which had been negotiated in November 1997 at their first meeting held in Krasnoyarsk, Russia, where agreement had been reached to work toward signing a bilateral peace treaty by the year 2000. The Hashimoto-Yeltsin Plan covered six areas of economic cooperation, including investment, the training of Russian entrepreneurs, and energy.

During this Kawana meeting, the two leaders agreed on the following: visa-free visits for Japanese scholars and cultural leaders to the disputed Northern Territories; a feasibility study of generators for the Northern Territories, which had been plagued by electricity shortages; an exchange of leaders of the two nations; and an untied loan of US$600 million from Japan to Russia, which would be part of a US$1.5 billion loan package that Japan, in cooperation with the World Bank, had pledged to provide during 1998–1999 (*Yomiuri Shimbun* 19 April 1998 and 20 April 1998).

Generally speaking, however, business relations between Japan and Russia have been cool. Japanese investors are reluctant to invest in Russia due to the shortage of capital for would-be Russian partners and the dangers posed by an underdeveloped Russian corporate tax system. Although Japanese sentiment toward Russia has improved markedly, investors continue to view Russia as a risky proposition. However, the two governments have agreed to establish a joint investment promotion company to enhance Japanese investments in Russia. Exactly what kind of "company" is yet to be determined; discussions between the two governments are ongoing (*Nihon Keizai Shimbun* 21 April 1998).

The issue of financial resources is critical to revitalizing Japanese investment in Russia and engaging Russia in the Asia Pacific economy. Such engagement requires Japanese investment as well as Russian money, so it is necessary to establish the mechanisms whereby new money can be supplied to Russia. To achieve this, Japan should assess its current economic relationship with Russia, fully examine projects for developing the Russian Far East, and submit concrete ideas to engage Russia in the Asia Pacific economy.

JAPANESE VIEWS ON ECONOMIC TIES WITH RUSSIA

Positive shifts have taken place. Since October 1993, when the Tokyo Declaration was adopted, people-to-people contacts and training programs at the national and local levels have helped to improve relations. The agenda for bilateral dialogue now includes politics, security, economics, and environmental protection.

The main reason for this favorable change is the transformation of the Russian regime. As Russia has sought support for its economic recovery, it has looked to Japan as a potential source of trade and investment.

Japan has also changed. A July 24, 1997, speech by Hashimoto to the Association of Corporate Executives marked a shift in political and psychological attitudes toward Russia. In his speech, Hashimoto suggested that "it would not be good for relations between neighbors such as Japan and Russia to remain at the current level, either in terms of the interests of Japan or Russia or the Asia Pacific region overall. Improvement in this bilateral relationship is without doubt one of the most important issues facing both of our governments as we approach the twenty-first century." He added that he had told Yeltsin directly at the previous month's Group of Eight summit in the U.S. city of Denver that "we must improve Japan-Russia relations with a view to creating new cooperation," to which Yeltsin "responded reassuringly" (Hashimoto 1997).

Large-scale ventures undertaken with Japanese participation have shown progress. The Sakhalin-2 oil and gas project is one such example.

Projects of this nature have the potential to unlock the vast energy reserves of Northeast Asia and so contribute to the political stability and economic growth of the region.

Even so, there is a pervasive pessimism in the two countries over bilateral relations. This pessimism is rooted in a negative historical legacy and huge cultural differences. There is also the problem of a wariness of Russia on the part of Japanese owing to lingering impressions from the cold war era. In addition, bilateral relations lack shared concepts and efficient organization.

Japan is also faced with daunting domestic economic problems, and Japanese industry is endeavoring to restructure in order to survive international competition. Yet potential partnership with Russia could strengthen both countries economically. Japanese industry has long experience with Russia, having enjoyed big business back in the Soviet days.

Japan could help Russia a great deal in this transition period. If Japan contributed to the economic rehabilitation of Russia based on principles suggested by Hashimoto of trust, mutual benefit, and a long-term orientation, both countries could have a fruitful future. Indeed, the two countries are neighbors and complement each other economically.

ECONOMIC RELATIONS BETWEEN JAPAN AND RUSSIA

The icy relations between Japan and Russia began to thaw in June 1997. Russian First Deputy Prime Minister Boris Nemtsov visited Japan and charmed his Japanese hosts with his thoughtful, pragmatic, and business-minded attitudes. For example, he suggested that he was ready, and that it was in his interest, to assist with large-scale capital flows from Japan. Subsequently, in July 1997, Hashimoto announced that Japan would base future relations on trust, mutual benefit, and long-term cooperation. The Krasnoyarsk and Kawana "no-necktie" summits with Hashimoto and Yeltsin followed, signaling strong intent to improve relations between Russia and Japan.

Even though political relations between Russia and Japan have improved, trade and investment relations remain sluggish. In 1995, Russia received a total of about US$3 billion in foreign direct investment, of which US$80 million (or 2.5 percent) was from Japan. Although total foreign investment in Russia increased to almost US$7 billion in 1996, Japanese investment decreased to US$20 million, or 0.3 percent of the total. In 1997, Japanese investment increased to US$139 million, or 1.1 percent of total foreign investment in Russia. But, in 1998, Japan dropped off the list of the top twenty countries invested in Russia (Japanese Association for Trade with Russia & Central-Eastern Europe, and the Institute for Russian & East European Studies 1999a).

In terms of cumulative investment in Russia, including portfolio investment and loans, Russia received US$26.02 billion by April 1999. Germany is the largest investor, at US$6.34 billion with a share of 24.4 percent. The other top five countries are the United States, at US$5.06 billion (19.4 percent); the United Kingdom, at US$3.45 billion (13.3 percent); France, at US$3.24 billion (12.4 percent); and Cyprus, at US$3.02 billion (11.6 percent). Japan is ranked ninth after Sweden, at US$340 million with the modest share of 1.3 percent (Russian National Committee on the Census 1999).

Trade between Japan and Russia is also relatively small. In 1998, trade between the two amounted to US$3.86 billion, with US$970 million in Japanese exports to Russia and US$2.89 billion in Japanese imports from Russia (Japanese Association for Trade with Russia & Central-Eastern Europe, and the Institute for Russian & East European Studies 1999b). This was a decline of 23 percent from 1997 to 1998, mainly due to the Russian ruble crisis in 1998. In 1998, Russia accounted for a mere 0.6 percent of Japan's total trade figures, 0.26 percent of Japan's total exports, and 1.07 percent of Japan's total imports.*

PROJECTS IN THE BAIKAL AND RUSSIAN FAR EAST

Oil and Gas Projects

The reserves of oil and gas in Sakhalinskaya Oblast, Republic of Sakha, and the Irkutskaya and Krasnoyarskaya Oblasts could play a significant role in meeting the energy needs of Northeast Asia. The estimated potential resources of Sakhalinskaya Oblast are 3,360 billion cubic meters of natural gas and 935 million tons of oil. The deposits of the Irkutskaya and Krasnoyarskaya Oblasts are estimated to be as much as 1,300 million tons of oil and 3,600 billion cubic meters of natural gas (Kalashinikov 1996).

With its current financial difficulties, Russia alone has inadequate capital to develop these energy reserves, so foreign investment is expected

*According to the Ministry of Finance (1999), in 1998 total Japanese exports amounted to US$377.75 billion and total Japanese imports were US$270.24 billion (US$1 = ¥130.19).

to play an important role. The cold climate and the lack of technology and equipment also make foreign oil and gas companies indispensable to developing these Russian energy resources.

In addition, the relatively small Russian domestic markets for natural gas and oil make it unlikely that Russia would develop the Baikal and the Russian Far East reserves for its own needs. Therefore, plans to connect these gas fields with pipelines to such neighboring countries as China, Japan, Mongolia, and South Korea are crucial for the projects' feasibility.

The Sakhalin-1 consortium originated in a general agreement between the Japanese company Sakhalin Oil and Gas Development Co., Ltd. (Sodeco) and then Soviet Foreign and Trade Ministry in 1975. It was reorganized in 1995 with Rosneft-Sakhalin (Russia), Sakhalinmorneftegas-Shelf (Russia), Sodeco (Japan), and Exxon (United States). This project is focused on developing the Arkutun-Degi, Chaivo, and Odoptu fields off the eastern coast of Sakhalin Island.

The Sakhalin-2 project began in 1991, and since 1994 has been developed by the Sakhalin Energy Investment Company Ltd., an international joint venture between Marathon (United States), Mitsui (Japan), Royal Dutch Shell (the United Kingdom and the Netherlands), and Mitsubishi (Japan). Sakhalin Energy is exploring and developing the Piltun-Astokhskoe and the Lunskoe fields 15 kilometers off the northeastern coast of Sakhalin Island. Commercial oil production started in July 1999 and liquid natural gas production will start in 2003. The total cost of the project is estimated to be US$10 billion.

Projected trunk pipelines will service both Sakhalin-1 and Sakhalin-2, and will link these oil and gas fields to the southern coast of Sakhalin Island.

These oil and gas development projects are important for the economy of the Baikal and the Russian Far East, particularly Sakhalinskaya Oblast and Khabarovsky Krai. It is estimated that during the implementation of both Sakhalin-1 and Sakhalin-2, about US$19 billion will be paid into local coffers. The machine-building and construction industries of Khabarovsky Krai and Primorsky Krai could have the unique experience of being flooded with orders, and tens of thousands of new jobs could be created.

The Siberian Land Bridge Project

The Siberian Land Bridge (SLB) is an international transportation system combining the services of railroads, trucks, and ships for conveying containers between Russia, Europe, and Central Asia (see Tanaka 1998).

The main artery of this "bridge" is the Trans-Siberian Railway, construction of which began in 1891 for transporting materials and immigrant labor to the Russian Far East. Opened in 1916 with the completion of the Amur Railway Bridge, the Trans-Siberian Railway is about 9,300 kilometers long, starting at Vladivostok and ending in Moscow. From there it connects to other railroads that link it to St. Petersburg and the European cities of Berlin and Budapest.

The idea of the SLB was realized in 1965 when a Japanese export company shipped timber bound for Finland from Yokohama via Otaru, Hokkaido, to Nakhodka and then used the Trans-Siberian Railway. In 1971, a regular sea line was opened between Nakhodka and Japan. The transit point was later changed from Nakhodka to Vostochny, and chartered trains began to be used for the transit of freight.

The greatest advantage of the SLB is in distance and time. Transporting freight from Yokohama to Rotterdam via the SLB is 13,000 kilometers, compared with 20,700 kilometers via the Suez Canal. The difference in time is twenty-five days versus thirty days. Moreover, the SLB proved to be more appropriate for conveying refrigerator containers than the sea route.

The number of containers transported by the SLB peaked in 1983. In the beginning of the 1990s, usage fell dramatically due to instability from the dissolution of the Soviet Union. Fuel and electricity costs shot up as a result of price liberalization, as did tolls for the SLB and charges for port facilities and ships. In contrast, the costs involved in using the sea route were lowered.

The Hashimoto-Yeltsin Plan was a statement of joint support for the SLB, particularly for modernizing the transportation network. Russian management personnel, including officials from the Ministry of Economic Affairs and the Ministry of Railways, were invited to Tokyo to discuss practical concerns with officials from Japan's Ministry of Transport. Japan is now implementing its practical support.

The Tumen River Area Economic Development Project

The Tumen River project aims to develop the Tumen River delta near the Chinese-North Korean-Russian border as a center for commodity distribution, trade, and industry (see Kageyama and Nishikata 1998). Developing transportation routes from Northeast China to the Sea of

Japan and enhancing trade within the region are included in the plans.

The United Nations Development Programme decided in its Fifth Work Plan, 1992–1996, to participate in the Tumen River Area Development Program. A Program Management Committee (PMC) was established in 1992, with the membership of China, North Korea, Mongolia, South Korea, and Russia, to exchange and coordinate views about the project.

At the sixth meeting of the PMC in December 1995, the member countries agreed to establish the Tumen River Area Development Coordination Committee and the Consultative Commission for the Development of the Tumen River Economic Development Area and Northeast Asia.

The third intergovernmental meeting was held in Beijing in November 1997, with PMC countries and other countries interested in Tumen River development projects attending. The agenda included capital mobilization, environmental protection, and tourism promotion. Discussions also addressed opening the Sino-Russian border to foreigners and commencing direct international flight services to and from the region.

Japan was invited to the second meeting of the Consultative Commission in October 1997, but it chose to remain an observer. As of the summer of 1999, there is no progress on Japanese involvement in this project. Based on future prospects though, Japan would do well to participate in the project and so work to further regional political and economic stability.

THE ECONOMIES OF ASIA AND RUSSIA

Asia's economic turmoil was set off by Thailand's devaluation of the baht in July 1997. In Thailand, the ruling Chavalit Yongchaiyudh government lost domestic support in the face of mounting public distrust, and the Chuan Leekpai government took office in November 1997. Once hailed as a model of development-oriented dictatorship, Indonesia was dragged down by economic problems stemming from widespread nepotism in the Suharto regime. President Suharto was forced to resign in May 1998, with Vice President B. J. Habibie replacing him. In South Korea, the investigation into past presidential corruption proved to be less than exhaustive and the government's failure to act swiftly vis-à-vis the problems of the nation's huge conglomerates resulted in the won coming under great pressure. Like Thailand and Indonesia, South Korea was forced to request aid from the International Monetary Fund (IMF). Thailand, Indonesia, and South Korea each shared unstable political situations, nonbank lenders being saddled with huge debts, and current account deficits.

Meanwhile, Japan was challenged by serious credit problems in its financial institutions, a situation that a strong yen exacerbated. China faced the thorny issues of both its state enterprises and its banking sector being heavily indebted, and the key question for the region was whether China would be able to resist devaluing the yuan.

The Russian economy was not able to escape the effects of the Asian financial crisis. At the end of 1997, Russia was showing signs of economic recovery and it recorded significant progress—so much so that many felt its economy had bright prospects. Inflation declined to 11 percent in 1997 from 22 percent in 1996, while economic growth showed a modest increase for the first time since economic reform began in 1992. Moreover, a trade surplus of US$33.1 billion was recorded in 1997. This progress was expected to be sustainable.

Yet the perspective that the Russian economy was riding a rising current was dashed by the emergence of critical new factors. The most damaging of these were the fall in the international price of oil—Russia's biggest foreign currency earner—and the withdrawal of foreign capital from Russia due to the Asian financial crisis.

On May 27, 1998, Russian Prime Minister Sergei Kiriyenko announced a tripling of interest rates—to 150 percent—to defend the ruble. This effort, however, did not eliminate pessimistic views about the Russian economy; rather, a Russian financial crisis was considered inevitable. This was so for at least three reasons. First, total Russian national debt was 44 percent of gross domestic product. Second, Russia had to redeem US$63 billion of US$75 billion in government bonds by the end of 1998. Third, Russian government bonds comprised 34 percent of national expenditure.

On August 17, 1998, unease about the Russian financial system was actualized. Prime Minister Kiriyenko announced that the ruble would be allowed to fluctuate between 6 and 9.5 rubles to the dollar until the end of the year. He also said there would be a ninety-day moratorium on servicing foreign debt, as well as a restructuring of government bonds before the end of 1999 (Radio Free Europe/Radio Liberty 1998a) Although the Russian government did not admit to this being a devaluation of the ruble, the ruble lost two-thirds of its value in two weeks (Fossato 1998).

The Russian government's financial measures of August 1998 further damaged the Russian banking sector. Deprived of liquidity, payments, and salaries, many Russian banks, including three of the "big seven"—Inkombank, Menatep, and Oneximbank—declared bankruptcy. Only eight months earlier, in January 1998, the "big seven" of Alfa, Inkombank, LogoVAZ, Menatep, Most, Oneximbank, and SRS-AGRO were said to control half of Russia's economy (Radio Free Europe/Radio Liberty 1998b).

The Russian government has struggled to regain financial credit. At the end of July 1999, for the first time since the August 1998 crisis, Russia received approval for an IMF loan program of US$4.5 billion. But unease about Russia will continue so long as there is no improvement in the Russian government's control over its finances.

As in Thailand and Indonesia, the financial crisis strongly impacted Russian domestic politics. President Yeltsin dismissed Kiriyenko as prime minister on August 23, 1998. Although Yeltsin failed to get former Prime Minister Viktor Chernomyrdin reinstalled, he succeeded in getting Russian parliament approval of Foreign Minister Yevgeny Primakov as prime minister that September. In May 1999, Yeltsin dismissed Primakov as prime minister and did the same three months later with his successor, Sergei Stepashin. Vladimir Putin is the new Russian prime minister.

CONCLUSION

Relations between Japan and Russia have improved, but little expansion of trade and investment has taken place. Japan feels that Russia must work to stabilize its economy; bring its legal, tax, and accounting systems up to international standards; and eradicate the activities of the Mafia and other economic criminals.

Russia has a full complement of problems, but Asia Pacific countries would do well to try to get along with Russia. This is especially evident regarding the Baikal and Russian Far East regions. Asia Pacific countries have a big opportunity here to strengthen economic relations through trade and investment, which would directly improve living standards in these areas. If Asia Pacific countries export their technology and capital to these regions, the Baikal and Russian Far East will be able to export their natural resources to Asia Pacific.

The Japanese government has made concrete efforts to improve relations with Russia, particularly in the strategically important Baikal and Russian Far East regions. Yet obstacles remain. One typical example: The Sakhalinskaya Oblast administration needs to reconstruct its international airport. The Japanese Export-Import Bank is ready to finance the project, but according to Organization for Economic Cooperation and Development guidelines, a borrower has to bear 15 percent of the total cost of the project, rather like a down payment. The Sakhalinskaya Oblast administration has asked the Japanese contractor to underwrite this percentage, maintaining that it will guarantee repayment. As the bank has been unwilling to accept this guarantee, the project could not go forward for a very long time, due to a shortage of approximately US$10 million. And Sakhalin is in relatively better financial shape than other regional administrations.

The IMF, the World Bank, and the European Bank for Reconstruction and Development are in fact currently working with Russia on special financial arrangements, but financing has concentrated on projects in Moscow and central Russia. The Baikal and Russian Far East regions have gone without financial assistance, which is one reason for the worsening regional economic situation. Accordingly, Asia Pacific countries may find it desirable to establish their own special financial mechanisms.

Such financial resources should concern themselves exclusively and specifically with projects that are indispensable to the economies of the Baikal and Russian Far East regions. As these regions lack funds for the down payment on projects to be financed by foreign governments, priority should be given to such financing. Finally, the mechanisms should be international in nature, with the governments of Asia Pacific countries investing in them in order to develop and foster economic ties with the region.

If these kinds of mechanisms can be established, projects in the Baikal and Russian Far East regions will be able to move forward, facilitating the engagement of Russia—and especially these regions—in the Asia Pacific economy.

The Japanese and Russian governments have agreed to establish a joint investment promotion company to enhance Japanese investment in Russia. With such a company, Japan would have a good opportunity to create multiregional, multipurpose financial mechanisms—together with Asia Pacific partners—to support the Baikal and Far Eastern regions.

The days of illusion and overexpectation have passed for Russian people. Asia Pacific countries might now work with Russia to put to positive use the financial resources Asia Pacific offers so that the Russian people may live better economic lives.

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