

THE POLITICAL AND ECONOMIC RATIONALE FOR THE INTEGRATION OF THE RFE INTO THE NORTHEAST ASIAN ECONOMY

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Why is there growing interest in the Russian Far East in cooperating with Japan and the United States? In my remarks today, I will argue that this trend in part reflects dissatisfaction with regional relations with China, but also can be attributed to changing economic priorities in the regions.

Research for this presentation is drawn from a larger project about center-regional differences in Russia's Asia policy. The project involved field work in Primorskiy Kray, Khabarovskiy Kray, Sakhalin Oblast, and Amur Oblast about economic relations between these regions and the United States, Japan, China, and South Korea, especially in trade, transportation (shipping) and natural resources (energy and timber).

Reorientation of Regional Economic Relations to the Chinese Market

When the Soviet Union collapsed in 1991, so did the economic links integrating the Russian Far East with European Russia. Previously the Russian Far East sent its raw materials to European Russia in exchange for consumer goods and raw materials. Once market prices were introduced, the high cost of transportation and energy made these arrangements too expensive to continue. Consequently, in the early 1990s, the regions of the Russian Far East reoriented their economic relations to their nearest neighbor China: they bartered resources for Chinese food and consumer goods.

Initially, Sino-Russian regional economic relations developed steadily. By 1993 trade between the Russian and Chinese border regions accounted for 2/3 of the \$7.68 billion bilateral trade balance. The boom in border trade proved to be short-lived, however, leading to a 34 percent drop in bilateral trade in 1994. To this day, Sino-Russian trade never regained its early momentum and, at \$5.7 billion in 1999, still is far short of the \$20 billion in annual turnover that Jiang Zemin and Boris Yeltsin pledged to achieve by 2000.

Disillusionment with China

Difficulties in Sino-Russian regional relations have been an important factor in restraining the development of economic relations between Russia and China. By the mid-1990s officials in the Russian Far East became disillusioned with Sino-Russian regional economic ties for four reasons.

1. Different Views of Regional Balance of Power.

While officials in Moscow saw the strategic partnership with Beijing as a means of countering the threat they perceived from NATO expansion and U.S. unilateralism, in the Russian Far East there was a different perception of the balance of power. For regional leaders confronting demographic and economic decline, China is the main potential threat. Although in the early 1990s the Russian border regions depended on border trade with China for necessary goods, by the middle of the decade regional officials feared that opening the largely unregulated border to economic activity with China—with its large population, unemployment problem, and

historical claims to Russian territory—could have serious geo-economic consequences for the Russian border regions by inviting Chinese control over Russia's weakened peripheries. As a result, regional leaders called for new federal visa rules and local police measures to regulate Sino-Russian economic relations.

2. Overstated Economic Complementarities with China.

In the early 1990s, the prospects for Sino-Russian economic relations were oversold, as policymakers in Moscow and Beijing pointed to the complementary features in the Russian and Chinese economies which would be instrumental in promoting economic cooperation between the two neighbors. According to this logic, since Russia has abundant land and natural resources and China has a large labor force, together the two countries could achieve mutually beneficial economic cooperation. This type of cooperation proved politically unpalatable in the Russian border regions, however. Regional leaders, concerned about local unemployment and the social consequences of an influx of Chinese economic migrants, were opposed to any large-scale use of Chinese labor as well as to becoming a "Third World resource-supplier for China." Instead, regional leaders hoped to attract foreign investors to revive processing industries (and create new employment opportunities) at home.

3. China's Relatively Small Role in Trade and Investment.

Because China's northeast shared many of the same problems as the Russian Far East—an economy based on resource extraction and heavy industry (especially from military enterprises in need of conversion) and a lack of investment capital—the Russian and Chinese border regions are unlikely to resolve their economic difficulties together. Despite the high hopes of the early 1990s, for the most part, China has played a relatively modest role in the economy of the Russian Far East. This is clear if we examine three regions more closely.

Sakhalin China is not among the region's top trade partners, which are Japan, South Korea, and the United States. The PRC's investment in Sakhalin is miniscule—less than one percent in 1999. Thus far the region has attracted more than 10 percent of all funds invested in Russia and ranks second after Moscow as a destination for foreign investment. The United States is the leading investor in Sakhalin with about \$1 billion or 80 percent of total cumulative investment in 1999, although Japan also has played a key role. Many top U.S. and Japanese firms are involved in the oil and gas projects and South Korean firms have played an active role as suppliers.

Primorskiy Kray South Korea is the leading source of imports, but China is in number two spot due to the region's reliance on cheaper Chinese products since the August 1998 financial crisis. Japan and the United States are the main export destinations. Chinese investment in Primorskiy Kray is insignificant (0.6%) despite the large number of joint ventures—South Korea, Japan, and the United States are the top investors in the region. For example, the United States invested \$100 million in a Coca-Cola plant, and the Hyundai Corporation put \$90 million into the Hyundai hotel in Vladivostok. The Korean Land Corporation plans to invest \$1 million to build office buildings and factories on the site of the Nakhodka Techno-park.

Khabarovskiy Kray This region is more of an exception because the Sukhoi fighter aircraft that China buys are produced there. China's 1998 purchase put it in top spot for exports (57%). Moreover, since the 1998 financial crisis, China has become the main source of food products

for the region. Even in Khabarovsk, however, China accounts for just six percent of investment. The United States and Japan are among the main investors, especially in the timber sector.

4. China, North Korea (Moscow's Preferred Partners) as the Main Economic Competitors for the Russian Far East.

During the last decade, policymakers in Moscow have focused on the strategic partnership with China as the key element of Russia's engagement in Asia and more recently the Putin government has sought to repair Russia's relations with North Korea. However, from the vantagepoint of the Russian Far East, China and North Korea are potential competitors for transit cargo, not key partners. This is one of the main reasons why officials in Primorskiy Kray were hostile to an initial plan by the Tumen River Area Development involving the construction of a new Chinese port as part of the Tumen area. However, the North Korean ports of Rajin and Songbon eventually may compete for Chinese cargo now going through Primorskiy Kray ports of Pos'et and Zarubino.

Reasons for Interest in Expanding Economic Relations with the US and Japan

For the political and economic reasons just outlined, Sino-Russian regional economic relations failed to live up to their initial promise. As a consequence, by the mid-1990s, the Russian Far East increasingly turned to the United States and Japan for investment capital to develop infrastructure, promote local processing industries, and reduce regional economic dependence on Moscow.

1. Need for Investment Capital

If the regions of the Russian Far East are looking to the United States and Japan for investment, this is due to Moscow's failure to deliver promised regional development funds. During his 1996 presidential campaign, Yeltsin pledged \$34 billion in federal funds for a new regional development plan for the Russian Far East and the Trans-Baikal, but to date only a fraction of this amount has been disbursed. To redress funding shortfalls, regional officials have turned to the United States and Japan. For example, in the summer of 1999, Japan agreed to fund a feasibility study for the construction of the Bureiskiy hydropower plant in Amur Oblast, a project included in the 1996 plan. Japan also contributed \$30 million to a feasibility study investigating improvements for the port of Zarubino. In May 1999, Japan agreed to invest \$10 million to build new facilities in Zarubino for grain storage, wood chip processing, and container transshipment. Infrastructure improvements in Zarubino would expand Primorskiy Kray's role in intra-Asia transit trade and make the port more competitive with Chinese and North Korean ports. Japan also is considering 20 power plant improvement projects as part of 1997 Kyoto CO₂ reduction program.

2. Reduce Economic Dependence on Moscow

The dependence of the Russian Far East on energy imported from other areas of Russia greatly increases the cost of production and reduces the competitiveness of locally produced goods. For this reason, the contribution of the Sakhalin offshore oil and gas projects to the gasification of the Russian Far East will be crucial both to improve local economic conditions and to reduce regional dependence on Moscow. As I mentioned previously, the United States is

a leading investor in the Sakhalin projects and American companies have been involved in planning future delivery, including various gas pipeline and LNG transport options.

3. Develop Processing Industries

To move away from resource extraction as the dominant source of regional income, regional officials have sought to attract investments that add value. There are a few examples of successful U.S.-Russian and Japanese-Russian joint ventures in resource processing, such as the Technowood plant in Primorskiy Kray, which produces construction materials for the Japanese market, and the U.S.-Russian joint venture, Tunaichi Wards Cove in Sakhalin, which produces caviar and crab for the Japanese market.

Prospects for Cooperation between the RFE, Japan, and the United States

Interest in the Russian Far East in expanding economic relations with the United States and Japan has found resonance in some regions of these countries. Some states on the U.S. West Coast have been active in promoting economic cooperation with the Russian Far East. Alaska was the first to get involved in this part of Russia. Alaskan Senator Ted Stevens played a key role in attracting U.S. government support for technical assistance programs originating in Alaska. Washington State also has been very interested in promoting trade and cooperation with Primorskiy Kray—the state has a permanent trade office in Vladivostok. The American Business Center director in Yuzhno-Sakhalinsk also serves as Alaska’s representative to the Russian Far East.

Similarly, the Japanese prefectures located along the Sea of Japan have been playing a leading role in promoting cooperation with the Russian Far East, despite impediments to the improvement of Russian-Japanese bilateral relations. In particular, Hokkaido has been playing a prominent role on Sakhalin, the region administering the disputed Kurile Islands. The prefecture has its own office in Yuzhno-Sakhalinsk, and, according to Sakhalin Oblast officials, is the most active foreign representation on the island. In the absence of forward movement on key issues of Russian-Japanese bilateral relations—the peace treaty and islands issue—Japan has been expanding its cultural and diplomatic presence on Sakhalin. The Japan Center there provides free Japanese lessons and assistance to small businesses with business plans. A new consulate is opening on Sakhalin this year.

Regional cooperation mechanisms have helped link the Russian Far East with interested regions in the United States and Japan. The U.S. West Coast-Russian Far East Working Group, established in 1994 under the Gore-Chernomyrdin Commission on Russian-American Cooperation, has played an important role in facilitating cooperation between these regions in a wide range of spheres, including energy, transportation, fishing, the environment, tourism, and investment. Other organizations help promote cooperation between the Russian Far East and Japan, such as the RFE-Hokkaido governors association, and the RFE-Keidanren association. Cooperation with South Korea is less developed institutionally but growing. For example, KOTRA has had a permanent office in Vladivostok since 1992 and has played an important role in promoting trade, joint ventures, and shipping projects. According to the Association of the Russian Far East and the Trans-Baikal, the lack of corresponding regional organizations in China has made it more difficult for the Russian and Chinese regions to cooperate. To redress this problem, a coordination council on Sino-Russian regional issues was created in 1998 as a part of the Working Group of Intergovernmental Commission on regional and border cooperation.

Changes in U.S. and Japanese policy toward Russia have supported the trend toward regionally driven cooperation with Russia. Frustrated by the lack of transparency in the assistance programs going through Moscow, the U.S. government has become more interested in assisting Russia's regions directly. For example, the Russian Regional Initiative, which includes the Russian Far East as one of its target areas, was set up to stimulate small business development, provide technical assistance in environment, and support educational projects.

In Japan, former Prime Minister Hashimoto's July 1997 Eurasian initiative led to an effort to separate economic and political issues in Russian-Japanese ties. Since economic cooperation has centered on the Russian Far East, Hashimoto's policy has had the effect of promoting Russian-Japanese regional relations. Cooperation has included humanitarian aid to hospitals and assistance with dismantling nuclear submarines in the Russian Far East.

Economic and Political Barriers to Cooperation

Nonetheless there are limits to regionally driven cooperation between the Russian Far East and neighboring regions in the United States and Japan. Even though Hokkaido has been targeting Sakhalin for economic cooperation, the Japanese government forbids Japanese companies to invest on the Kuriles, pending the resolution of their status.

The level of risk involved in investing in the Russian Far East, as elsewhere in Russia, creates the greatest obstacles. Although the largest U.S. and Japanese firms are involved in the Sakhalin oil and gas projects, even these ventures have not been without their share of difficulties. There are some smaller success stories in joint ventures involving U.S. and Japanese cooperation, but there are also main prominent failures, which have reinforced caution among potential foreign investors.

According to Japanese diplomats, Russia's ineligibility for official development assistance (ODA) credits makes it more difficult for Japanese firms to invest in Russia, compared to Central Asia, for example, which is eligible for ODA credits. Since Russia is not classified as developing country, it can't receive ODA credits and projects would require guarantees and investment from both governments, often very difficult to achieve from the Russian side.

Center-regional tensions further complicate regional projects. For example, the State Duma has failed to approve necessary implementing legislation for the production-sharing (PSA) agreements for the Sakhalin oil and gas projects. At times federal and regional laws conflict and complicate progress on these projects.

Regional politics create additional barriers to foreign investment by the United States and Japan. Although the Russian Far East would like to attract foreign investment, regional officials at times try to use the threat of foreign control for short-term political gain. Primorskiy Kray Governor Nazdratenko is a prominent example. He warned of the threat of foreign control over the region's shipping even while he was trying to attract U.S. shippers to a new trade route, focusing on his region's ports. Even on Sakhalin, viewed by foreign business people as relatively supportive of foreign investment, the Oblast Duma speaker called for auditing oil companies' books and the regional administration advocated enlisting the assistance of the FSB in monitoring the activities of foreign companies on the island.

Conclusions

The Russian Far East and the neighboring regions of the United States and Japan share some overlapping interests, which work to increase economic cooperation. However, a number

of constraints have served to limit this momentum, especially the unstable investment climate. The difficulty in moving forward with regional cooperation is in part the result of inadequate regional policy in Russia but also of legacy of closed regional economies. The integration of the Russian Far East in Asia is likely to be a long-term process, involving multilateral projects in transit trade and energy with American and Japanese participation but also including the PRC and the Koreas.