

# *Investing in the Russian Far East*

Fourth-Annual US-Russian Investment Symposium  
Oct. 5-7, 2000, John. F. Kennedy School, Harvard University

Kyoji Komachi  
Managing Director, Japan International Cooperation Agency

## **1. Emerging new opportunities**

The year 1999 was a unique year. It was the very first year in which the Russian Far East registered positive industrial production of 7.5% since the collapse of the USSR in 1991. All three major regions, Sakhalin, Khabarovsk and Primorskii Krai, which account for more than 70% of industrial production in the Far East, showed positive growth. The figures were 10% for Primorskii Krai, 9% for Khabarovsk and 7% for Sakhalin respectively. This trend is likely to continue in the year 2000. This development has opened up new opportunities for the region, especially when this positive trend in the Russian Far East is related to other neighboring regions, which show continuing dynamic GDP growth. In particular, I have here in mind three provinces ( Liaoning, Jilin, and Heilongjiang provinces ) of northeast China, where GDP growth figures for the past three consecutive years stand above the national average. At the same time, as the first joint march of the two Korean teams at the Sydney Olympic Games opening ceremony demonstrated, we should not lose sight of the emerging prospect of a reunified Korea. In this context, the Russian Far East has to be recast as an integral part of the emerging Far East.

The year 1999 was unique for the Russian Far East in another sense, because it saw Sakhalin being raised to the position of number one among the 89 members of the Russian Federation in terms of volume of direct foreign investment; the volume being over one billion U.S. dollars for Sakhalin alone. Of course, this is related to the Sakhalin-II project, which started oil production in July 1999. There is also what is known as the Sakhalin I project, which is expected to start commercial production of oil around 2006. The total investment volume of Sakhalin-I and Sakhalin-II combined will eventually reach the level of 25 billion U.S. dollars. In addition, Sakhalin III and IV projects are expected to follow.

There are other prospective big energy development projects such as the Kovikta gas field near Irkutsk as well as the Yakutia oil and gas fields. These projects have strategic energy implications, because continuing rapid economic growth in China will inevitably be accompanied by an increase in demand for energy, thereby straining the existing energy balance in Northeast Asia. These natural gas development projects may allow the East Siberia and Far East regions of Russia to become net suppliers of energy, including electricity, for the region. There is also another area of potential for the Russian Far East; this is the reinstatement of the Siberian Land Bridge (SLB) as a route between the Asia-Pacific region and Europe. The SLB has fallen into disuse with the collapse of the USSR, and the ensuing confusion irreparably damaged the

commercial efficiency of the route. Since the early 90's, cargo flow originating in the Far East has shifted from the SLB to ocean routes. With the reappearance of dynamism in the region and rapprochement between the two Koreas, we can again hope for a new strong tide of cargo flow through the SLB.

## **2. Impediments and Solutions**

### **(1) Unsolved joint-venture court cases**

With the only exception of Sakhalin, the Russian Far East has failed to attract the level of investment it would like to achieve. Foreign capital from Japan and other countries is not rushing in because there are impediments to investment decisions. The traditional target of foreign direct investment ( FDI ) from Japan has been timber logging. Since Russian employees in such joint ventures cannot hope for alternative employment, joint ventures in this field have been doing well. This dictates a close cooperative relationship between Russian and Japanese partners. Immediately after the collapse of the Soviet Union, when businesses from both Japan and Korea ventured into the area of service sector investments, particularly hotels, they set foot into a quagmire. It was very often the case that an initial honeymoon period would turn quickly into animosity. The majority of investment cases relating to the service sector have failed and currently there is virtually no appetite to enter this sector either in Japan or Korea. In the service sector, Russian partners in joint ventures assume that they can successfully continue to do business without foreign partners, and they are uninhibited about resorting to forcible take-over bids. But collapses of partnerships have tarnished the image surrounding foreign direct investment in the Russian Far East. It is very important to restore this image. In relation to this, all Japanese business people are hoping for a fair verdict by the Russian judiciary concerning a particular Russia-Japanese joint venture hotel in Sakhalin, which at the time of its inception was heralded as a model for other Japanese businesses to emulate.

### **(2) Population outflow**

The problem of population outflow is another impediment to investment. The Baikal and Far East regions of Russia witnessed an outflow of about 790 thousand people over the period between 1990 and 1998. The population in the Far East was only 7 million and 260 thousand as of the end of 1998. Unless this outflow trend is stopped or reversed, business prospects are likely to remain bleak.

### (3) Lack of necessary infrastructure for FDI

Impediments are not limited only to forcible take-over bids or population outflow. East Siberia and the Far East are not unique in their negative characteristics relating to foreign investment. The latest polls of leading Japanese companies taken at the end of August cite such reasons as an unclear legal and tax framework, survival of distinct Soviet-style book-keeping, unreliability of statistics including data in financial statements, inadequate level of incentives for attracting FDI, and lack of reliable banking services for such basic requests as issuance of letters of credit. These points are widely known. The Russian leadership, including Mr. Putin, is very much aware of them. The polls were presented to Mr. Putin when he met with Japanese business leaders, and he promised to improve the investment climate in Russia, taking them into account. During the meeting, he stressed that the recent appointment of presidential representatives in 7 regions would secure the unified application of federal laws throughout Russia. He also referred to the impending reform of the Russian judiciary system in order to secure such unified application of law.

There are a few specific points I would like to make at the policy level.

1) A more transparent relationship between Moscow and the regions;

The first point is related to the evolving relationship between Moscow and the regions under the Putin administration. Here we would like to see a more transparent and mutually beneficial relationship develop between the federal and regional governments. For example, I would like to ask Moscow to develop a customs policy more favorable to the regions that results in exportation of goods directly from Japan, Korea or China into the Far East, which makes more commercial sense than exporting the same goods through Moscow via specified organizations that are entitled to import goods duty-free. I understand there exists a certain argument for fiscal federalism in Russia, but Moscow should also be more willing to exercise discretion relating to matters concerning the establishment of free economic zones, for example. I have one specific case in mind, which I will return to later.

2) Development of regional economic policy;

The second point I would like to make is this: I urge the regions of the Far East to stop vying with each other and to try to develop themselves into a more coherent and comprehensive economic policy entity, as this will be required in the face of the myriad problems which impede FDI and require speedy solutions at the regional level. This is particularly important to overcome the negative impact of population outflow in the region.

3) More flexible border-trade regulations;

The third point is connected with the regulatory environment relating to border trade. Apparently, border crossing in the Far East is still very time-consuming. One distinct disadvantage for promoting border trade relates to the multiple inspection procedure still administered by

Russia in the region. In the Khasan border checkpoint of northeast China, for example, inspection involves two stages of passport control, customs clearance and another two inspections by the military. Russian inspection is complicated and much more fragmented than that of China. We can improve the situation, where appropriate, with the help of modern technology like computers, but problems remain from the standpoint of checkpoint operations. For example, there are still some border checkpoints open only 8 hours a day. In addition, new initiatives for simplifying visa regulations are urgently needed.

## 3. New prospects

### (1) Implications of rapprochement between the two Koreas

The unexpected summit meeting between the two Korean leaders in June this year opened up a whole new range of prospects for the development of Northeast Asia. This historic turn of events could bring a series of positive changes. For example, in the event that a railway connection between the two Koreas is reestablished, the Trans-Siberian Railway could be extended as far south as Pusan at the southern tip of South Korea. This could, in turn, generate quite a different flow of cargo between the Asia-Pacific region and Europe. Cargo flow between South Korea and northeast China as well as the Russian Far East would be very active, with intra-regional and cross-border business flourishing. In the same vein, the Tumen River Region Development Project, which involves Russia, China, Japan and the two Koreas, could be revitalized. A possible exception here might be the seaports of the Russian Far East, on which there could be a detrimental effect. A serious and negative result of rapprochement between Seoul and Pyongyang could be for the political situation in South Korea to force the bulk of available capital for FDI in South Korea away from the Russian Far East and concentrate it instead on North Korea.

### (2) Dynamic northeast China

China presents another significant factor to be reckoned with. Given the continuing strong economic boom in China, the flow of trade in the Far East region may drastically change in the future. With the standard of living rising in leaps and bounds, the Chinese people naturally desire better housing conditions, and building new houses would trigger a rapidly rising level of timber exports from the Russian Far East. There are also cases where Russians in the Far East have exported logs to China for processing before subsequently re-exporting them to South Korea and Japan. Economic growth in China would also increase the demand for an improved diet among the population. China is now No. 1 in the world in terms of its catch of fish, having overtaken Japan. It may therefore be natural to expect the fishery and other food-related businesses to become another area for joint ventures in the Russian Far East.

Given the huge potential of the U.S. market, the

northeastern provinces of China may strive to increase exports to the U.S., and this could encourage Chinese exporters to utilize Russian Far East ports, which are located more conveniently than available Chinese ports.

### (3) Strategic energy cooperation and establishment of the Free Economic Zone in Nakhodka

Energy is another strategic area for economic partnership in the Far East. Here again, energy-importing China could be a locomotive for such cooperation. In this regard, Russian East Siberia and Far East is probably the only area with potential for energy export.

South Korea was eager to invest in the Russian Far East, having in mind the possible homecoming, particularly to Primorskii Krai, of ethnic Koreans deported by Stalin to Central Asia. In this context, South Korea was keen to develop the Russia-Korean Industrial Complex in Nakhodka as the first free economic zone in Russia. South Korea has apparently done everything it can at the government level to start this project. However, the Russian Parliament is reluctant to accord such a status to the project. Here again we are confronted with the delicate and sometimes intractable relationship between Moscow and the regions. It is our hope that the Putin administration will resolve this matter.

## 4. Japanese response and initiatives

Russian-Japanese trade is in poor shape according to official statistics, as is the case with investment. Japan ranks NO.13 and 14 for investment and trade in Russia respectively. But as former Prime Minister Kirienko said in his article ( Japan Times, June 12, 1998 ) “ due to the unaccounted transshipment of sea products outside the Russian customs border in the Far East alone, we annually lose \$2.5 billion .” The bulk of these products are exported to Japan. Another invisible factor in official trade statistics concerns second-hand passenger cars which Russian seamen purchase in Japan, bring back to the Far east technically as hand luggage, and sell at profitable margins - this arrangement allows the duty free import of the vehicles, thereby excluding them from trade statistics. The volume is so huge that a successful joint venture for servicing second-hand passenger cars was set up by a Japanese firm in the Far East with a \$2 million investment. Hence, the real level of economic exchange between Japan and Russia is much higher than official statistics suggest.

At a strategic level, Japan is fully aware of the importance of the Russian Far East and East Siberia. At the Moscow summit of 1998, both countries confirmed their readiness to interact in fostering international cooperation in the energy sector in the Asia-Pacific region to enhance energy security, support the resolution of global warming, and help the social and economic development of the region.

This summit produced a further initiative. It was the agreement for the promotion and protection of investments, related to which are three points that are worth noting:

- a) A commitment by Russia not to apply such trade-related investment measures as a local content requirement.
- b) A transparency clause which obliges Russia to make public all laws, regulations, administrative procedures and judicial decisions that pertain to or affect investments.
- c) An agreement to submit disputes to North American-style arbitration.

We were very relieved to see this agreement ratified by the Russian Duma in January of this year.

During President Putin's visit to Japan about a month ago, he noted the recent positive upturn in bilateral trade and touched upon the idea of an “ energy bridge ” of electricity between the Russian Far East and Japan, as well as the revitalization of the Trans-Siberian Railway. Some Japanese private companies have already expressed interest in these ideas.

Another area that has attracted keen interest among Japanese companies relates to sophisticated technologies in Russia, which have not been tapped for commercial application. A recent seminar on such technologies in Tokyo attracted an unexpected number of participants.

## 5. Conclusion

Let me conclude by presenting three points. As I noted earlier, Japan is currently rather lukewarm about investing in the Russian Far East. This is because Japanese businessmen have already had their fingers burnt with various joint venture failures, which has led to negative perceptions spreading among business circles. That is why Prime Minister Mori stressed to President Putin the importance of the Russian judicial system delivering a fair verdict concerning the joint hotel venture in Sakhalin, otherwise China and Korea will become more attractive options for investment from the Japanese point of view. Therefore, I would urge Russian businessmen to see with their own eyes what sort of privileges and incentives are accorded to FDI by China, particularly in areas neighboring the Russian Far East. China is a very formidable competitor vis-à-vis the Russian Far East.

Secondly, the Russian Far East, which has a population of only about 7 million, is not of sufficient size. Moreover, each of the regions of the Far East are quite independent from the others, resulting in this 7 million person market existing only on paper and not in reality. In addition, Moscow, particularly the Duma, is not inclined to delegate sufficient economic power to the regions, including the Far East. Under such conditions, project like the Russia-Korean Industrial Complex in Nakhodka will not progress. At the same time, the Russian Far East has to further develop its identity as one region, and we would like to see a more comprehensive regional economic policy emerge in this respect.

Thirdly, the rapprochement of the two Koreas is beginning to look as if it will be a real possibility. This would fundamentally change the investment climate of the region. It will become more pressing in economic terms

to think of the Russian Far East, northeastern China and some areas of Korean Peninsula as an indivisible whole. Japan would get involved, when appropriate, in such projects as the Tumen River Region Development project. And some areas in Japan facing the Sea of Japan are very much interested in this emerging Far East. As I tried to demonstrate, the Far East region is full of potential for development. We can tap this potential more effectively

when all players from Russia, China, Korea and Japan join hands and succeed in building a common concept for regional development in the region. As the Russians say, "In order to shake hands, you need two people to cooperate." I hope my remarks have helped you understand this and the problems we are facing. We are extending our hand. I hope you will do the same. Thank you very much for your attention.