

# Economic Links between the Far Eastern Provinces and Japan

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Over the course of its bilateral economic contacts with Russia, Japan was traditionally among Russia's ten leading trading partners. In the Asia-Pacific region, Japan was the main trading partner, but after 1992 moved into second place after China. On the other hand, both Russia and Japan constantly experienced difficulties in further developing their bilateral trade and investment links. Some of the obstacles were associated with the contradictions of the past, including the so-called territorial problem and the absence of a formal peace treaty. Recently, however, economic dialogue has become more active. In 2000 alone, Russian President Vladimir Putin visited Japan twice, the deputy chairman of the government also came to Tokyo twice and the Minister of Foreign Affairs visited Japan three times. During Vladimir Putin's second visit to Japan, an agreement was signed aimed at the deepening of economic cooperation.

Investment cooperation with Japan in the Far Eastern region is currently focused on several priority projects, including the completion of the Bureiskaya hydroelectric power station in Amurskaya Oblast, a major gas pipeline project running from Sakhalin - Komsomolsk-na-Amure - Khabarovsk - Vladivostok, a gas pipeline project from Srednevilyuyskoe gas-and-condensate field to Mastakh, Berge and Yakutsk in Republic of Sakha (Yakutia), and yet another gas pipeline project in Kamchatskaya Oblast. These projects were reviewed by the Far Eastern subcommittee of the bilateral intergovernmental commission on economic cooperation and Japan offered to cover the costs of the feasibility assessments, following a proposal advanced by the Keidanren. It should be noted that cooperation with Japan in the energy sector is extremely important for Far Eastern Russia, considering that in 1996 the Federal Government adopted a special set of measures aimed at wider utilization of local sources of energy (adopted on September 9, 1996, No. 1066).

However, there are differences in approaches to concrete projects in this field. For example, discussions on the hydroelectric power station project are yet to lead to a desirable outcome. In 1998-1999, the United Energy System of Russia (UESR) advanced a proposal to Japan to

conduct a pre-feasibility study to evaluate the cost of the completion of the project and prospects for investment cooperation. The proposal was accepted and the Japan Bank for International Cooperation (JBIC) was named as a potential source of yen-denominated credit funds channeled through Japanese trading companies under the condition that half of the equipment needed for the project would come from Japanese manufacturers. It was also proposed that repayments should be carried out over 15 years, with an interest rate in the area of 7-8%, while repayments should be guaranteed by the central government and collateral in the form of hard currency proceeds from the project should be provided by the hydropower plant owners. These proposed conditions for project financing were not accepted by the UESR, but it seems that both sides are seriously interested in searching for appropriate options to work jointly on this and other priority projects.

As of today, trade relations with Japan remain much more important than investment cooperation, but the scale of trade relations is limited. In addition, their nature has changed dramatically over the last ten years. Russia practically discontinued its large-scale imports of industrial equipment from Japan and boosted exports of raw materials, particularly non-ferrous metals and fish. The trade balance rapidly changed in favor of Russia as imports from Japan declined (Table 1).

On the other hand, foreign trade became highly decentralized, with more than 4,000 organizations participating in export-import activities in the Far Eastern region alone. This trend, however, seems to be typical of the whole of the Far Eastern region's trade with foreign trading partners.

## Bilateral Trade

The latest statistical data for trade available in Japan, which covers the first six months of 2001, show that Russia-Japan bilateral trade increased by 3.6%, reaching US\$2.4 billion. Imports from Japan increased by 7%, but comprised only about one-seventh of Russian exports, which grew by 3%. Non-ferrous metals (aluminum, palladium and platinum) accounted for 46% of total

Table 1. **Russia - Japan Bilateral Trade**  
(Unit: Billion Dollar)

	1995	1996	1997	1998	1999	2000
Exports	4.7	3.9	4.0	2.9	3.7	4.6
Imports	1.2	1.02	1.01	1.0	0.5	0.6
Total	5.9	4.9	5.0	3.9	4.2	5.2

Source: *Inter-regional Association of Economic Coordination "Far East and Zabaikalie"*

exports, followed by fish (21%), timber (18%), coal (4.7%) and ferroalloy (1.8% of total exports).

Almost 30% of goods imported from Japan take the form of passenger cars, buses and trucks, followed by telecommunications equipment (7.5%), construction, mining and loading machinery (9%), rubber goods (6%), and precision machinery (4% of total imports).

As far as the Far Eastern region is concerned, its total exports to Japan in the first six months of 2001 amounted to US\$273 million. In reality, its exports originated from only three provinces-Primorskiy Krai (US\$122 million), Khabarovskiy Krai (US\$98.5 million) and Sakhalinskaya Oblast (US\$51.4 million). Imports from Japan by July 2001 totaled US\$63 million, including US\$57 million absorbed by the same provinces.

In 2000, export volumes for the entire Far Eastern region increased by 80%, while imports declined by 21%, compared with 1999. In the same period, the total foreign trade volume of the Far Eastern provinces increased by 40%, reaching \$3.5 billion, including a \$2 billion trade surplus, but imports from Japan to the area declined and export volumes in 1998-2000 stagnated (Table 2). Moreover, total Russia-Japan bilateral trade turnover increased 20% in the same period, reaching \$5 billion.

The crisis of 1998 considerably altered the Russian market, strengthening the competitive position of exporters. At the same time, demand capacity on the part of potential importers remained low with only a limited number of solvent companies contributing to imports from Japan. As far as exports are concerned, Russia remains a supplier of raw materials, which account for more than 90% of total exports, including logs and timber products, fish and sea products, nonferrous and precious metals, and coal. From Japan, Russia buys machinery, including transportation, electrical and electronic equipment. The volume of Japanese investments in Russia is also low, although formally speaking Japan is the eighth largest foreign investor in Russia. In the Far Eastern region, Japanese investors have contributed to the realization of a number of capital-intensive projects, including the construction of the international air terminals in Khabarovsk and Vladivostok, and the fiber-optic line between Khabarovsk, Tokyo and Seoul.

In general, the whole of the Far Eastern region's exports are based mostly on raw materials, including fish and marine products, timber and wood products, and coal. Despite the fact that the list of exportable goods includes more than 100 items, about 80% of total export earnings comes from only four items, including fuel, lumber, fish and marine products, machinery and equipment. Furthermore, the combined share of Japan, China, the

Republic of Korea, and the United States in the foreign trade of the Far Eastern region is about 70%. Far Eastern Russia's trade with Japan is the most important component of bilateral economic ties, reflecting both geographical proximity and the availability of raw materials, including commodities that Japan imports in large volumes.

### Role of the Provinces

However, not all Far Eastern Russia's provinces maintain substantial trade contacts with Japan. Khabarovskiy and Primorskiy kraia and Sakhalinskaya Oblast are the leading provinces of the Far Eastern region in terms of trade with Japan. However, a combination of various unfavorable factors and market trends recently contributed to a decline in their trade links with Japan. For example, in 2000, Khabarovskiy Krai, which has a leading position in trade with Japan, accounting for 30% of the entire trade volume, saw exports decrease by 17.6% to a level of only \$190 million due to decreased shipments of lumber-the main export item from this province. On the other hand, imports from Japan (machinery, equipment and spare parts) fell by 22% to \$34.6 million. The volume of Japanese investment in Khabarovskiy Krai is only \$3.1 million, an increase of \$200,000 compared with 1999. Most of these funds are invested in the lumber industry and wood processing enterprises. In the first six months of 2001, Khabarovskiy Krai received US\$5.3 million in investment from Japan.

Primorskiy Krai-the second in terms of trade volumes-also saw its turnover reduced by 5% to \$170 million in 2000, compared with \$198.5 million one year earlier. Similarly to Khabarovskiy Krai, Primorskiy Krai exports to Japan are much higher-in total \$148 million worth of lumber, fish and marine products, and petroleum products-than imports from Japan, which were limited to only \$22 million, including machinery, motor vehicles, equipment and spare parts. Moreover, in 2000 imports fell by 10% in comparison with 1999.

Primorskiy Krai occupies the second position in the Far East, by virtue of its having attracted more than \$38 million of Japanese investment in 26 enterprises, including such joint ventures and fully-owned enterprises as "Technowood", "Terneyles", "Vostoktelekom", "Summit Motors", and "Ditolla". "Technowood" produces glued beams, utilized in housing construction in Japan. Sumitomo Corporation provided "Technowood" with a \$20 million credit in the form of technological equipment for the production of laminated plywood and this credit will be repaid with finished products from this enterprise. In the first six months of 2001, Primorskiy Krai received US\$18.6 million in investment from Japan.

Table 2. Far East and Zabaikalie: Trade with Japan  
(Unit: Million Dollar)

	1995	1996	1997	1998	1999	2000	2001, January-June
Exports	1,100	879	1,011	694	616	621	272.7
Imports	190	195	241	157	133	116	63.3
Total	1,300	1,074	1,252	851	749	737	336

Source: *Inter-regional Association of Economic Coordination "Far East and Zabaikalie"*

Another of Japan's important trading partners is Sakhalin, which is located close to Hokkaido. In 2000, Sakhalin's trade with Japan totaled \$160 million, including \$125 million of exports—mainly lumber, fish and marine products, and bituminous coal. In comparison with 1999, the volume of goods imported from Japan grew by 14% due to the increased number of motor vehicles, equipment, petroleum products and food. In 2000 alone, Sakhalin received \$247.4 million of foreign investment, a large share of which originated in the United States. Furthermore, major Japanese companies are involved in offshore oil and gas projects in the northern part of the island. In terms of investment collaboration, Sakhalin is well positioned to be the prime target for Japan.

By 2001, the total volume of Japanese investment in the Far Eastern region was estimated at US\$103.6 million, with 120 enterprises registered in Sakhalinskaya Oblast, including 32 enterprises wholly owned by Japanese investors. Ninety enterprises were registered in Khabarovskiy Krai, and 26 in Primorskiy Krai.

### Weakening Ties

Despite some positive developments, the fact remains that Japan, after decades of supremacy in trade and economic contacts with the Far Eastern provinces, is now witnessing a weakening of its economic presence in Eastern Russia in both relative and also absolute terms. In the last three years, the bilateral trade volume for the Far Eastern region and Japan decreased by 30%.

It seems that among the factors behind this situation is the tradition of linking economic cooperation with outstanding political problems between the two countries, which is still alive.

Recently, market trends in Japan for some raw materials imported from Russia were unfavorable. At the same time, the trade and investment connections of Far Eastern enterprises have gradually diversified, leading to Japan's decreasing share in foreign trade because companies from other countries enter Far Eastern markets and import more from local producers. For example, in 2000, Japan's share in the foreign trade turnover of the Far East and Transbaikal region declined by 8% points in comparison with 1999, compared with a 7% points decline for the United States.

On the other hand, exports to China from Far Eastern Russia sharply increased to \$1,047 million due to rapidly expanding exports of fish and marine products (2.9 times),

soybeans (5.5 times) and crude oil (2.6 times). Exports to South Korea also increased by 80% to \$578 million, with crude oil's share reaching 58.6% of total exports. In addition, although exports of timber to Japan have been declining since 1997, South Korea and China buy more of these products from Eastern Russia than Japan does. Imports from China and South Korea were lagging behind but increased by 6% each compared with 1999, due to an increase in purchases of food and food products (China) and knitted fabric (South Korea).

Overall, this diversification makes the trade relations of the Far Eastern region more balanced and the interests of exporters better protected in terms of their reduced dependence on a single market. On the other hand, importers in the Far Eastern region also enjoy a more competitive environment. A startling example of this is the fact that the Far Eastern region's imports from the United States (\$115 million in 2000) are now almost equal to imports from Japan. Furthermore, in terms of composition these two are comparable, considering that the share of machinery, equipment, motor vehicles, and spare parts in imports from the United States increased to 50%, compared with the 59% share of these and similar items in imports from Japan.

### Problems to Solve

Although the Far Eastern region is economically attractive to Japan, its market is underdeveloped and unsophisticated. The legal framework necessary to facilitate trade and investment is weak. The banking system is also fragile and this complicates credit access for enterprises and the expansion of their trade operations. Infrastructure required by foreign investors, including reliable transport links, advanced telecommunications and power and heat supply is inadequate. Markets in general and individual enterprises in particular are not transparent and there is no established system of insurance and protection from investment risks. International accounting standards are yet to be introduced. In addition to the tax burden and criminal practices, complex and inefficient customs procedures and visa regulations are hindrances to doing business in Russia.

The first and most important issue, however, is that the Far Eastern enterprises lack the funds needed to import goods from Japan, while the list of exportable products is limited to just a few commodities with relatively low competitiveness by international standards. It seems that

Table 3. **Far East and Zabaikalie: Trade with Japan by Provinces**  
(Unit: Million Dollar)

	1997	1998	1999	2000
Republic of Sakha	177.1	43.4	96.6	118.1
Primorskiy Krai	410.6	324.0	198.5	170.0
Kamchatskaya Oblast	126.2	86.7	37.5	40.7
Khabarovskiy Krai	318.9	195.7	255.3	224.6
Amurskaya Oblast	15.3	27.8	0.014	9.4
Magadanskaya Oblast	19.8	12.6	6.3	13.5
Sakhalinskaya Oblast	174.3	142.4	137.0	160.0
Republic of Buryatia	4.2	3.9	9.4	8.5

Source: *Inter-regional Association of Economic Coordination "Far East and Zabaikalie"*

further development of economic cooperation with Japan is complicated, among other factors, by the absence of a peace treaty between the two countries and unsettled debts left over from the Soviet era.

Second, a "two-step loan" system is required to facilitate the financing needed for Russian enterprises to pay for imported production equipment. Moreover, credit lines-tied and untied-opened by Japanese banks to their counterparts in Russia could help launch and promote programs to develop trade relations and specific investment projects.

Third, more can be done in the area of "priority" projects selected for bilateral cooperation, particularly in the Far Eastern region's energy sector, including the abovementioned gas pipeline projects, the modernization of power plant No. 4 in Khabarovsk, the installation of diesel fuel filtering equipment at the oil refinery in Khabarovsk, the introduction of a combined cycle gas turbine at Amurskiy power and heat producing plant No. 1, the development of coal reserves in Sakhalin (Solntsevskoe field) and Yakutia (Elginskoe) and the production of oil and natural gas from the Talakanskoe oil and gas field in Yakutia.

In 2000, the economic situation in the Far Eastern region improved and many enterprises and main industries registered a growth in output. The greatest increases in production volumes took place in the energy sector. The output of oil, including gas condensate, grew by almost 80% in comparison with 1999 as production expanded in the Republic of Sakha (Yakutiya) and Sakhalinskaya Oblast, where the Sakhalin Energy company (Sakhalin-2) obtained about 1.7 million tons of oil from the shelf. Production of natural gas increased by 3.5 % and electric power generation by 5% with the exception of Primorskiy Krai. In oil refining, primary petroleum refining volumes increased by 22%.

Fourth, in addition to projects in the energy sector, there is a shared interest in a proposal aimed at using the Trans-Siberian railway for containerized cargo transportation between Northeast Asia and Europe. This will help Russia to improve its access to the markets of Northeast Asia and, on the other hand, will benefit Japan in terms of faster transportation times to and from European markets at a competitive cost.

Fifth, improvements in the investment climate deserve special attention, including the introduction in the Far Eastern region of "special development conditions" that, through various institutional arrangements and adjustments in immigration, border-crossing and customs regimes, will encourage the inflow of foreign direct investment from the neighboring economies of Northeast Asia and funds from multilateral funding agencies, including the Asian Development Bank.

Finally, there is a need to develop a joint program for tourism promotion, including measures aimed at infrastructure development for all possible modes of transport and the sustainable use of available resources. The solution of these problems will make it possible for Russia-Japan trade and investment relations to recover from their present stagnation.

## Positive Trends

In 2000, the volume of industrial production in the Far Eastern region increased by 5.9%, unemployment decreased and household disposable income recovered somewhat compared with the pre-crisis level in 1998. Among the industries that experienced growth were electricity generation and oil and gas production, as well as lumber, cardboard and paper, cement, composite ferroconcrete articles, and a number of other investment goods. Furthermore, economic recovery with a greater reliance on the domestic market fostered by import substitution was reflected in the expansion of construction work, and growth of transportation volumes and other services.

The combined output of oil refineries increased by 22%, with exports of diesel fuel and heavy oil from Khabarovsk oil refinery growing rapidly. Logging enterprises in Khabarovskiy Krai also boosted output volumes by 40%, providing 60% of the lumber production of the entire Far Eastern region. Sawn timber production increased by 17% in general and by 23% and 44% in Khabarovskiy Krai and Yakutia. Cardboard, pulp and paper production also showed a moderate increase. Also, in Yakutiya, there was an increase in coal production at Neryungrinskiy and Zyryanovskiy coal basins, with about 32% of coal produced in this province being exported to Japan. A gas pipeline project was completed in Khabarovskiy Krai, linking Komsomolsk-na-Amure with Amursk (74.5 kilometers). A longer natural gas pipeline (418 kilometers) is under construction in Kamchatskaya Oblast, and yet another one is under way in southern Sakhalin.

On the manufacturing front, 10 multipurpose SU-30MKK jet fighters were assembled in Komsomolsk-na-Amure, with 30 of these due to come online in the next few years. In Primorskiy Krai, machine-building and metal-cutting enterprises boosted their output by 80%, accounting for 14% of the industrial production of this province. In Amurskaya Oblast, machine-building and metal-cutting output increased by 30%, while in Evreiskaya Autonomous Oblast, some industrial enterprises resumed business after several years of idling.

In fisheries, towards the end of 2000 the monthly catch increased by 32% compared with 1999, but the total annual catch decreased to 2.3 million tons, or 11% lower than in 1999. This output represents only half of the volume produced in 1990 and is 26% percent lower than in 1997.

Compared with 1999, capital investment in the Far Eastern region increased by 6.7%, reaching almost 39 billion rubles, however in Primorskiy Krai, Sakhalinskaya and Evreiskaya oblasts there was a decline in investment activity. On the other hand, housing construction in Primorskiy Krai increased by 6%, while in Khabarovskiy Krai and Sakhalinskaya Oblast it rose by a startling 30% and 90% respectively.

All these developments point to the fact that there are expanding opportunities in the Far Eastern region for investors and exporters from Japan. These opportunities include, first of all, export and leasing of motor vehicles, construction and other types of equipment. Also, there

could be a significant expansion in fisheries, including coastal fishery fleet development and technological upgrading, as well as in certain segments of the agricultural sector. Some niches suitable for manufacturing enterprises

from Japan could be found in Primorskiy and Khabarovskiy krais, particularly in developing and upgrading wood-processing, pulp and paper production, and manufacturing construction materials for the housing sector.

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