

Russia and Japan Beyond 2005

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In 2005, Japan and Russia celebrate the 150th anniversary of the establishment of diplomatic relations. In addition, the centenary of the signing of the Peace Treaty in Portsmouth, as well as the 60th anniversary of the end of World War II, require that we assess past events in bilateral relations, as well as considering the paths that the two neighbors may choose in the future. This essay attempts to briefly review the existing currents in bilateral economic ties and envisage some potential building blocks for the economic partnership between the two countries in the longer term.¹

An Encouraging Geo-political Context

At the Japan-Russia Summit held in Bangkok in October 2003, the leaders agreed to establish a policy-oriented expert-level framework to exchange views on a broad range of bilateral issues as part of their efforts to improve the environment for the conclusion of a peace treaty. Indeed, Japan and Russia are the only major powers that have yet to achieve complete normalization, due to the lack of a treaty with agreed borders. Nonetheless, one must also recognize that the bilateral interface is now qualitatively different, being more positively focused than ever before.

Certainly, this interface is not perfect: there is significant room for improvement. Further advancement requires leadership and a working institutional framework. However, like it or not, the role of politicians and their supportive bureaucracies is becoming less dominant. In contrast, the world is changing and global competitive pressure requires that both countries respond to groundbreaking economic trends and geo-political shifts. It seems that pressing economic needs and changing interests, as well as emerging non-military concerns will define the transformation of the bilateral agenda for decades to come. Factors unimaginable just two decades ago create a demand for innovative approaches, including those relating to steering policy dialogues, investment decisions and rapidly increasing grass-roots interactions.

The reality is that the role of the US in Japan-Russia relations has changed dramatically. Since 1991, Russia's political leadership no longer defines its security priorities in the context of confrontation with Washington or its allies. In general, Moscow seems to be free from openly antagonistic relationships with other countries and does not threaten any other state. The military forces on both sides of the Cold War divide were downsized and the risk of large-scale war practically vanished. The new relationships with NATO are guided by the idea of partnership. Military-to-military exchanges with Japan were also developing quite

rapidly, contributing to policy dialogue.

From 2001, personal bonds with the leaders of the US, Germany, Italy, France and the UK became stronger and more meaningful than at any point during the last century. New geo-political interests are now supportive of closer economic ties. Links with the West appear so much different today, now that Moscow is a fully-fledged G8 partner. In fact, other members of this group are more inclined to compete with Japan in promoting their own trade and economic interests.

However, there are numerous specific areas in which strengthened cooperation could unmistakably serve the interests of both sides. One such area is the DPRK. Japan and Russia agree that the DPRK must be prevented from developing nuclear weapons. However, both countries need to envisage how and under what specific conditions they could support the reform process, providing economic and technical assistance in rebuilding infrastructure and normalizing the energy supply in the north of the Peninsula. Provided that the nuclear issue is resolved through diplomatic means and an agreement on a nuclear-free Korean Peninsula is reached, trans-Korea infrastructure projects could become physically possible, including a power grid, railroad and a pipeline for transporting natural gas.

Yet another close link is assistance in the program for the dismantling of old nuclear submarines. Under phase two of the bilateral "Star of Hope" project, five Russian nuclear submarines are to be dismantled: four of them in the town of Bolshoi Kamen, near Vladivostok, and the other in the town of Vilyuchinsk in Kamchatka. The first 18-month stage involved the dismantling of the Viktor-3 class submarine. The full plan envisages dismantling about 40 nuclear submarines by 2010.

In the field of international organizations, Japan assisted Russia in joining the Asia-Pacific Economic Cooperation (APEC) forum. Tokyo supports Moscow's bid for accession to the World Trade Organization. In the context of the reform of the United Nations, Russia has reiterated its support for Japan's becoming a permanent member of the UN Security Council, giving broad consent on the draft framework resolution of the G4 countries.

Investment Climate

Obviously, economic limitations, particularly those on the Russian side, were mostly to blame for sluggish progress in business contacts over the last decade. However, Russia has attained macroeconomic stability and made significant progress in repaying its foreign debt. In 1999-2004, annual GDP growth was above or close to 7%, while

¹ This paper was presented at the international conference *portsmouth and its Legacies*, commemorating the Centennial of the Russo-Japanese Peace Treaty of 1905. The conference took place on September 8-10, 2005, at Dartmouth College in Hanover, New Hampshire.

industrial production in 2004 expanded by 6%. Capital expenditures increased by 11% and investments from all sources were estimated at approximately \$100 billion.

For a number of years, Japanese business leaders basically agreed that the investment climate in Russia was not sufficiently favorable. However, by 2005, accumulated foreign investment exceeded \$82 billion, including \$40 billion attracted in 2004. The share of foreign direct investment (FDI) was 23.3%, while portfolio investment occupied 0.8% of the total volume. About 80% of the entire influx, including 78% of FDI, originated from Cyprus, Netherlands, Germany, the UK, the US and France. Most foreign funds were focused on the industrial sector (the oil industry in particular), retail trade and catering, and commercial operations. Russia's economic image was gradually changing, influencing its credit rating. In 2003-2005, the leading credit agencies, including Moody's, Fitch, and Standard and Poor's awarded Russia with an investment level credit rating. According to the international consultancy A. T. Kearney, Russia now occupies the 11th position in the list of economies most appealing to foreign investors, equaling China in this respect.

From 2004, Russia underwent fundamental changes in the system of state management. This reform is aimed at reducing the excessive involvement of the state in economic affairs, dismantling barriers to entrepreneurship, protecting property rights (including copyrights and intellectual property), harmonizing technical standards and providing a regulatory framework.

The tax pressure has been reduced considerably, contributing to the investment capacity of enterprises. From 2004, the tax rate for operations with stocks and securities was lowered from 0.8% to 0.2% of the nominal emission volume. Value-added tax was reduced to 18%. A law signed in July 2004 reduced social tax rates and expanded the list of activities covered by the simplified tax regulations. Amendments adopted in 2005 aim at the promotion of competition in the context of anti-monopolistic regulations.

In September 2004, the government adopted a plan aimed at promoting the development of financial infrastructure, thereby reducing the risks involved in entering the financial markets. In July of that year, the government adopted a strategy of developing the banking sector, aimed, amongst other things, at eliminating discrimination against foreign investors. In addition, the maximum foreign share in insurance companies has been raised to 25% and some regulations were abolished for firms in which the share of foreign ownership was less than 49%. In addition, a law was adopted that liberalized the

currency market. New legislation will soon be introduced to establish transparent rules for companies operating in natural resource-based industries. The government is also set to introduce international accounting standards for listed companies and has initiated new legislation on preventing money laundering and improving the transparency of banking institutions.

Economic Links

It is quite likely that bilateral trade may exceed \$10 billion in 2005-2006, demonstrating an exceptional dynamism (Table 1).

Although the volume of bilateral trade is not large by Japanese standards, it has doubled over the last seven years. For Russia, Japan is an important trading partner, but until recently it was not on the list of the top ten export destinations, nor the top ten sources of imports. Official statistics, however, are incomplete because they register only direct imports. Exports to Russia via third countries would add another \$3-4 billion, making Japan Russia's fifth-largest trading partner.

The composition of Russia's exports to Japan remains focused on grass-roots sectors, including precious and non-ferrous metals (37%), fish and marine products (27%), timber (11%) and fuels (20%), including coal, oil and oil products. In 2004, Russia occupied the 25th position in the list of Japan's export destinations, behind Vietnam. In terms of Japanese imports, Russia was in 21st place, positioned between Kuwait and Switzerland. In absolute terms, bilateral trade constitutes only about 10% of Japan's trade with the ROK and 5% of that with China.

According to Russian official sources, cumulative Japanese investment to 2005 reached almost \$700 million, including \$140 million of direct investment. Again, the Sakhalin projects and investments made via third countries accounted for \$2-3 billion, making Japan the fifth-largest investor. In 2003 alone, investment in the Sakhalin projects reached \$1.0 billion, which brought the cumulative volume close to \$2 billion, including \$800 million of accumulated FDI.

Currently, there are more than 80 representative of fices registered only in Moscow. According to a survey by the Japan Bank for International Cooperation (JBIC), Russia has been elevated to the top ten geographic destinations for business expansion. This is remarkable progress compared with the situation in 2001, when it was not found even among the top thirty attractive countries for Japanese companies. However, given the traditional caution in dealing with Russia, the complexities of the

Table 1. Russia-Japan Bilateral Trade, 1998-2005

	1998	1999	2000	2001	2002	2003	2004	2005 (1 st half)
Exports	2.9	3.7	4.6	3.9	3.3	4.2	5.7	2.3
Imports	1.0	0.5	0.6	0.7	0.9	1.7	3.1	1.5
Total	3.9	4.2	5.2	4.6	4.2	5.9	8.8	3.8

Source: Ministry of Economic Development and Trade, Russia

Table 2. Loans by the Japan Bank for International Cooperation, 2002-2004

Agreement date	Partners	Recipients	Repayment (years)	Amount (\$1 million)	Project
March 6, 2002	Commercial banks	Vneshtorgbank	5	60	Imports of machinery and equipment
June 12, 2003	Bank of Tokyo-Mitsubishi	Moscow International Bank	5	20	Imports of machinery and equipment
September 2003	—	NEC-Neva JV		9	Equipment manufacturing and marketing
November 2003	—	Gloverbel Group (Asahi Glass)	—	108	Manufacturing plant construction
March 2004	—	Business Car JV(Toyota)		6	Marketing
March 30, 2004	—	Rostelecom		2.66	Equipment procurement from NEC

Source: Ministry of Economic Development and Trade, Russia

decision-making process and the lack of capacity (and, very often, incentives), it could take years before these changing attitudes are translated into concrete business projects. In this context, the role of JBIC in supporting business links could be crucial (Table 2).

At the same time, other institutional frameworks that prop up bilateral ties need to be developed further. In this context, the efforts of the US government to support the private sector's operations in Russia deserve attention, including the *BISNIS* framework and the *Commercial Service* representation offices established in Russia, as well as the offices opened under the *Regional Initiative* program - all funded by the Department of Commerce. Moreover, the *Commercial Energy Summit*, a public-private framework, was established by the leaders. This organization has elevated US-Russia bilateral dialogue at the ministerial level and the level of the leading energy companies. Similar institutions that support private-sector operations in Russia have been established by the European Union (EU).

Vis-à-vis these two mega-partners, Russo-Japanese cooperation cannot yet rely on the proactive role of their respective governments. Indeed, the current disposition is quite far from ideal, considering that in both countries the state and the private sector act mostly independently. In summary, in both countries, there is no government-funded entity that could support private-sector operations. In addition, there is little coordination among the existing government-level bilateral frameworks. In other words, both national and bilateral "lobbies" that should promote bilateral economic links are weak, or yet to be organized.

Sub-national Relations

It is well known that countries do not trade: businesses and companies do. However, in Japan-Russia relations, activities at the sub-national level could play an important supporting role, facilitating the flow of information and the formation of interest groups. Despite a trend towards greater centralization in Russia, regions possess considerable freedom in their external contacts. In highly disciplined Japan, on the other hand, regional decentralization is now perceived as an important tool in

reviving the economy. For example, Taizo Nishimuro, Vice-Chairman of Nippon Keidanren and Chairman of Toshiba Corporation, has raised the issue of a resolute shift from a system of centralized control to regional autonomy, local initiatives and decision-making, in order to sustain balanced nationwide development.

Some regions are now moving in this direction. A law on establishing Special Zones for Structural Reform has been enacted. Currently, more than a hundred such zones have been approved, granting exemptions from regulations in such fields as education, urban renewal, distribution, agriculture, medical care, and industry-academic cooperation. Over time, this could enhance the competitiveness of regions and municipalities, providing the means for the selective testing of new policies that enhance competitiveness and promote region-to-region links.

For Russia, these developments could be of significant value. The Far Eastern region represents a strategic border area, but it is economically and demographically at risk. The challenge is the weakened economic and transportation links between this part of the country and other regions in Russia, as well as a harsh climate and difficult economic conditions. It seems that a response strategy could be found in the field of strengthening infrastructure connections, including transport, telecommunications and energy delivery systems, but also in promoting small and medium-sized businesses. These could provide incentives for regional development, supporting at the same time closer economic links with neighboring states, Japan in particular.

Far Eastern Russia is the traditional area of interest for Japan, including Japanese companies and certain prefectures, including Hokkaido and Niigata. On the other hand, from the early 1990s, the economic wellbeing of several Far Eastern provinces depended heavily on trade with Japan, as well as other neighbors (Table 3).

In 2003, the bilateral trade transactions of Far Eastern Russia were close to \$7.7 billion, with exports consisting mostly of oil and oil products (32%), timber (15%), fish and shellfish (11%), coal (4%), metals (9%) and machinery (5%).

Table 3. Far Eastern Russia: Bilateral Trade with Japan 1998-2003

(\$1 million)

		1998	1999	2000	2001	2002	2003
Yakutia	Exports	33.7	106.3	111.7	27.8	—	138.9
	Imports	9.7	20.2	6.4	7.4	—	11.0
Primorskiy Krai	Exports	264.0	161.0	194.0	257.0	207.0	154.9
	Imports	60.0	38.0	32.0	47.0	74.0	221.7
Khabarovskiy Krai	Exports	178.3	213.3	190.0	180.0	148.0	169.2
	Imports	17.4	42.0	34.6	34.0	56.0	77.8
Amurskaya Oblast	Exports	12.1	9.0	6.8	19.3	16.3	21.9
	Imports	15.7	5.4	2.6	1.4	0.7	1.8
Kamchatskaya Oblast	Exports	123.5	64.4	81.9	50.5	76.7	70.6
	Imports	10.9	8.9	5.6	6.0	7.1	13.4
Magadanskaya Oblast	Exports	6.3	2.2	1.9	23.0	—	20.1
	Imports	6.2	4.1	10.9	9.4	—	12.7
Sakhalinskaya Oblast	Exports	121.7	123.6	135.5	94.0	201.0	293.5
	Imports	20.7	21.4	38.9	84.0	27.3	144.6
Total	Exports	739.7	679.8	722.2	652.0	649.3	869.2
	Imports	140.6	140.1	131.3	189.3	165.1	483.0
Total trade		880.3	819.9	853.5	841.3	814.4	1,352.2

Source: Inter-regional Association “The Far East and Trans-Baikal Regions”

Japan accounted for almost \$1.4 billion, or 22% of total trade, following China (37%), but staying ahead of the ROK (15%). Japan’s imports from the Far Eastern region approached \$880 million, including oil and oil products (25%), timber (21%), coal (20%), and fish and shellfish products (15%).² Japan’s exports to the Far Eastern region of Russia consisted mainly of passenger cars and trucks (35%), steel pipes and rolled steel (20%), and construction and earthmoving machinery (9%). Province-wise, the leading trading partners of Japan were Sakhalin Oblast (\$438 million), Primorsky Krai (\$377 million) and Khabarovsk Krai (\$247 million). Sakhalin was far ahead in terms of Japanese investment (\$784 million), followed by Primorsky (\$26 million) and Khabarovsk (\$2 million).

It seems unlikely that a conventional expansion of trade and evolutionary accumulation of Japanese investment in Russia would suffice to transform all these important, but minuscule economic exchanges. Rather, we should anticipate some mega-developments that could affect both the scale and the quality of economic links. The Sakhalin oil and gas projects are quite representative in this regard.

During his 2005 summit meeting with Junichiro Koizumi at Gleneagles, Vladimir Putin expressed his appreciation that Toyota Motor Corporation has decided to construct an assembly plant in St. Petersburg, promising his full support for this venture. The leaders discussed progress in implementing the “Japan-Russia Action Plan”. They agreed that Putin will visit Japan on 20th-22nd November. The leaders also affirmed the strategic importance of an oil

pipeline project to Russia’s Pacific coast.

The Oil Pipeline Impasse

The Pacific oil pipeline project is now part of Japan-Russia and Russia-China policy dialogues. Initially, the project was not designed to gain support from Japan. Nevertheless, Japanese energy planners became interested in it. Supportive remarks made by Koizumi when he visited Moscow in January 2003 paved the way for high-level exchanges, working-level discussions and technical visits. This ignited hopes that Japan could become a partner in the project. The expectations of an agreement were initially high on both sides, particularly in Russia. However, the process has stalled, leading to disappointment among its proponents, including the Transneft Company.

In order to understand the sources and mechanisms of such disappointment on the part of Russia, one has to review the role of Putin in the decision-making process centered on the Pacific oil pipeline and other critical infrastructure issues. It seems that he is strongly convinced that eastbound pipeline infrastructure is vital to Russia’s economic wellbeing, political integrity and international posture. Since his days in local government in St. Petersburg, transportation routes and related infrastructure have been an important part of Putin’s agenda, partly defining his long-standing personal links. For example, in 1996-1999, Alexei Miller, currently Chairman of the Board at Gazprom, served as director for investment and development at the Sea Port of St. Petersburg. In 1999-2000, with Putin taking over the

² The smuggling of fish and shellfish from the Pacific provinces to neighboring countries is perhaps the most notorious part of the underground economy in Eastern Russia. Officially, in 2003, such exports to Japan were estimated at about \$102 million. In reality, these figures represent only a fraction of existing exports.

reins of government, Miller was given responsibility over the Baltic Pipeline System (BTS). This project has now become a major infrastructure achievement.

Putin believes in state control over the trunk pipelines, including projects such as the BTS and the Pacific pipeline. Despite some differences in approaches relating to investment mobilization³, cabinet members have no other choice but to follow his view. Putin now discusses pipeline infrastructure issues on a regular basis with Miller, as well as with such key figures as Semen Vainshtok (CEO of Transneft). He does not shy away from chairing cabinet-level meetings on pipeline infrastructure development, with the most recent session having been held in early October 2004. He also discussed with the minister for natural resources the prospects for exploring and developing oil and natural gas reserves in Eastern Russia. On the other hand, he likes sharing his ideas with the leaders of Germany and France, as well as other G8 members, including Japan.

Putin's overall position in defining the pipeline routes could be perceived as Russo-centric. The earlier drafts of the *Energy Strategy 2020* stated the need to avoid the transit of oil and gas via the territories of "third" countries. Before visiting China, Putin explained that any decision regarding the destination of an oil pipeline will be based on Russia's national interests, including the development prospects of the Far Eastern provinces. On the other hand, he alluded to a comprehensive energy partnership with China.

As far as Japan is concerned, there was presumably a lack of confidence in the project's economics, including the reserves of oil available in Eastern Siberia, which are currently estimated at about 1,000 million tons (Mt). In total, about 40 new fields could be licensed as soon as in 2006-2007, with an additional 30 fields to be auctioned soon thereafter. As of today, discovered oil and gas fields, including Talakanskoe (Yakutia), Urubcheno-Tokhonskoe (Evenkia), Verkhnechonskoe (Irkutsk Oblast), as well as smaller fields, could allow production of 50 Mt of oil a year.

The long-term plan envisages enlarging the oil reserves by about 1,500 Mt by 2010, accompanied by a similar expansion in resource estimates. The cost of the program that would allow these increases is close to \$25 billion. Towards 2030, the estimated costs of the geological exploration and development of the new oil reserves could amount to \$50 billion.⁴ On the other hand, the plan envisages an initial supply of about 30 Mt of oil from Western Siberia. Moreover, the funding for the geological exploration and development of new reserves will be supported through the federal budget, but an international exploration-and-development consortium that could help alleviate investment risks could be established with the

participation of Japan. There is a strong expectation that President Putin's planned visit to Japan will result in more good news regarding this oil pipeline mega-project and related activities.

In this context, it is important to envisage the demand for Siberian and Sakhalin oil on the part of Japan. Currently, the capacity of the US to absorb oil from Eastern Russia is estimated at 15-25 Mt a year. A similar estimate could be applicable to the ROK and Taiwan combined. The remaining 30-50 Mt should find their way to China and Japan. A commitment on the part of these two economies to certain volumes of oil imports from Russia could be important for the overall design and commercial success of the project.

An Energy Partnership?

In a broader sense, extensive energy links could make Japan and Russia economically interdependent, promising significant benefits, but requiring closer policy coordination. According to Nippon Keidanren, Japan's Achilles' heel is energy. A stable energy supply must be secured, consistent both with environmental and economic concerns. Sources should be diversified to avoid the risk of over-concentration.⁵ Similarly, Russian energy planners propose to diversify energy exports, accessing new oil and gas markets in the Asia-Pacific region, Northeast Asia in particular. As of today, Russia's energy exports basically have only one predominant destination: Europe. The Russian government is proposing to diversify energy supplies to the "north, east and south", promoting energy production in new, capital-intensive environments, including Eastern Siberia, the Far Eastern region, the Arctic and the continental shelf of the Northern and Caspian seas.

The economies of Northeast Asia and the US are emerging as potential new destinations for Russian oil and natural gas. In May 2002, Moscow and Washington launched their "new energy dialogue". China, for its part, has been successful in lobbying for an export pipeline. Energy cooperation became part of the Japan-Russia Action Plan adopted in January 2003.

Energy exports to Northeast Asia seem to be becoming a priority target for Moscow. On the other hand, Russia is not planning to expand its energy exports to Europe in physical terms. Contrary to expectations, including projections by the International Energy Agency, the main provisions of the Russian Energy Strategy to 2020, adopted in August 2003, basically reflect this change in priorities. The Energy Strategy 2020 says that crude oil exports to the Asia-Pacific region could reach 105Mt a year - a little more than 2 million barrels a day - including 25Mt to be produced by the Sakhalin offshore fields. These huge

³ The decision on the Pacific pipeline was officially announced on 31st December 2004. The pipeline will be built in two phases, first to Skovorodino (2006-08), then to Perevoznaya Bay (from 2008), and the chief contractor of the project is Transneft. It is not yet clear how the project could be financed, but the option of using the extra revenue accumulated in the Stabilization Fund could be among the possibilities. The alternative could be a transportation tariff levied by Transneft, as well as taxation preferences and customs benefits extended to companies involved in the project.

⁴ Currently, the annual level of funding for geological exploration and development in Eastern Russia is a little more than \$100 million, only about 10% of the required investment level.

⁵ *Looking to Japan's Future: Keidanren's Perspective on Constitutional Policy Issues*, 18th January 2005, Nippon Keidanren (Japan Business Federation).

amounts will constitute about one-third of the projected Russian oil exports in 2020.

The plan also includes building a 4,200km crude oil pipeline, connecting the fields in Eastern Siberia and Yakutia and the existing trunk oil pipeline in Taishet, near Lake Baikal, with an export terminal on the Pacific coast. The price tag of this project is close to \$12 billion. If materialized, it could divert as much as 15% to 20% of Russia's total oil output and 25% to 30% of its oil exports to markets in Northeast Asia. Japan's trade minister, Shoichi Nakagawa, stated that Japan was willing to help "in every way possible", if Moscow gives priority to building the pipeline to the Pacific coast. However, plans to divert part of the oil to China upon the completion of the first phase of the project appear to be a problem.

With regard to natural gas exports, the share of Northeast Asia could reach 15% to 20% by 2020. Gas supplies to China and the Korean Peninsula via pipelines could reach 25 billion cubic meters (Bcm) by 2020. This is greater than the volume that the ROK currently imports as liquefied natural gas (LNG). Technically, a gas pipeline to the ROK could be routed via the DPRK, but a more viable option would be transit via China. A submarine gas pipeline between Sakhalin and Japan (Sendai or Niigata) has been proposed by ExxonMobil. Moreover, the Sakhalin II LNG project could export about 13 Bcm of LNG annually by 2015 and Japan is about to conclude contracts for half of this volume.

Bilateral energy cooperation potentially transcends export-oriented projects. To sustain domestic demand towards 2020, expand exports and modernize domestic energy industries, Russia needs between \$620 billion and \$850 billion, including \$260 billion to \$300 billion mobilized before 2010-2012. Most of these funds should originate from private sources and loans. Only the Sakhalin I and Sakhalin II international consortia, in which Japanese companies are involved, plan to invest as much as \$35 billion over the next decade or so, but several other oil and gas projects on the Sakhalin shelf are in the formation phase, requiring another \$30 billion to \$50 billion.

These and other projects would create huge business opportunities. Japanese investors and equipment manufacturers could participate in the construction of new power plants and delivery infrastructure and the modernization of existing facilities, as well as a broader reorientation of the Russian energy sector toward increased efficiency and added value. More generally, the development of energy industries is seen by the Russian government in the context of technological advancement and high-tech research and development. Technological cooperation in the fields of energy, fuels and emission reductions could benefit both countries, but these issues are yet to become part of the bilateral agenda. In addition, cross-border power interconnection is on the long-term list of priorities, with forecasts of electricity exports to China and the Koreans. Eastern Russia's unique hydroelectric power potential presents an opportunity for projects that are efficient both in economic and environmental terms.

Indeed, energy sector development contains significant potential for investment and trade, including new business opportunities for companies and investors. It seems,

however, that a new conceptual framework is needed to integrate these opportunities into the long-term policy agenda. One such example is the concept of "Asian Energy Partnership", which was publicized in April 2004 by the Ministry of Economy, Trade and Industry (METI) and is mostly aimed at promoting ASEAN+3 (Japan, the ROK and China) cooperation. This plan avoids explicitly mentioning the options relating to eastern Russia. On the other hand, it seems that leading companies could act beyond the bilateral frameworks. For example, some of them are working in partnership with Gazprom in the Stockman field project, which is not related to the Japanese market at all.

The Kyoto Protocol

It is important to make a brief mention of the Kyoto Protocol, which recently came into force as a result of its ratification by Russia. Under the Kyoto Protocol, the emissions volume in 1990 became the "base" level for Russia, as well as for many other countries that have signed up to the agreement. The Russian government tends to view the Protocol not as a "money bag", but as a "pilot agreement" designed to launch innovative economic mechanisms aimed at emission reductions and improved energy efficiency. It remains to be seen how Japan responds in the context of this agreement. Foreign Minister Nobutaka Machimura said that Japan welcomed the decision, indicating that his government has been approaching Russia on this issue on many occasions at various levels.

In general, by combining energy cooperation with efforts aimed at reducing emissions, the agreement could stimulate both bilateral and sub-regional economic links. In the context of Japan-Russia bilateral cooperation, the agreement could contribute to promoting renewable energy sources in Russia and exporting energy-saving technologies from Japan.

Among the cross-border projects are various options for power grid interconnection, natural gas pipelines, hydroelectric power and biomass energy. By investing in these environment-friendly ventures, Japan and other Annex II countries would increase the range of options available to them for meeting their Kyoto targets. However, to justify investment in large-capacity projects, these ventures must have market access.

On the other hand, Russia does need vast improvements in energy efficiency and new investment in the modernization of energy facilities. In Eastern Russia, renewable energy could replace obsolete thermal capacity in some cases. Given the abundant renewable energy resources in the eastern regions of Russia and very large markets for cleaner energy in neighboring countries, growth in renewable energy production could be significant. It is also conceivable that the Kyoto process would require active participation at the regional governmental level.

A Geo-economic Complementarity

Growing regional economic interconnectedness may require mutual support from Japan and Russia, which could potentially lead to investment projects that cover not a single market, but create a production and export platform that serves several regions.

METI estimates that by 2020, Asia will have a

25% share of world GDP, compared with 19% in 1990. As a result, the region is now seen as a huge market for commodities and consumer goods. Less widely appreciated is the fact that Asia is quickly becoming a hub for advanced research and development, as well as higher-end products.

Japan remains the second largest country in the world, bigger than all the rest of Asia combined. In 1992-2001, Japanese imports from East Asia surged from 31% to 43%, while exports to East Asia rose from 33% to 42%. It is estimated that more than 70% of the largest Asian companies on an annual turnover basis are Japanese. China has become Japan's largest trade partner, supplanting the US, while in 2003 trade with ASEAN accounted for about 15% of total Japanese trade.

In November 2004, during the ASEAN+3 summit in Laos, economic ministers decided to set up an expert group to study the establishment of an East Asian Free Trade Area. Russia needs much closer links with the economies of East Asia. Japan has been a key player in helping to promote Asian integration. This is being achieved through investments by private firms, as well as government grants to develop regional infrastructure, service operations and production capabilities. It now invests approximately 10% of its outbound FDI in East Asia.

Conclusions

In their bilateral relations, Russia and Japan have reached a point when the feelings of "remembrance and reconciliation" should prevail. The Portsmouth Treaty did not really work out well for various reasons, including revolutions, conflicts and wars in the years immediately after 1905. The post-1945 alliance obligations did change the geo-political currents further, completely altering the intermediary role of the US in Tokyo-Moscow relations. Today, relatively loose trade and industry links continue to reflect these century-long upheavals, as well as the limited capacity on both sides to interact economically.

The bottom line is that the new trade and economic links cannot be a part of policy bargaining any longer,

but appear to be mutually reinforcing tools in the pursuit of national interests, prosperity at the regional level and international stability.

In conclusion, bilateral economic interaction is moving ahead, promising significant mutual benefits. Firstly, the real level of bilateral economic exchange is much higher than official statistics suggest.

Secondly, mega-projects, including the Sakhalin oil and gas ventures, Pacific oil pipeline and similar projects could further motivate bilateral trade and investment cooperation.

Thirdly, the relationship with China has become one of the most important bilateral links for both Japan and Russia. China's demand for commodities, energy and manufactured goods represents a golden opportunity for both Russia and Japan, particularly if they could somehow complement one another on a long-term basis.

Fourthly, cross-border energy cooperation in Northeast Asia, focused on energy sector development in Eastern Russia, would enhance the energy security of the economies of this area, contributing to their international competitiveness and environmental sustainability, as well as the political stability of the region as a whole.

Fifthly, it seems that globalization intertwined with decentralization offers new opportunities for development and cooperation. New options for business links supported by the governments of provinces and prefectures should be carefully examined, while also bearing in mind that the central bureaucracies in both countries are still in control and are likely to remain the key channel for business-related communications.

Finally, both the expansion of contacts at the grassroots level, including the business elites of Japan and Russia, and their mutually beneficial geo-economic positioning are among the goals that are long-term in nature, but highly dependent on the overall international environment and leadership.