

## Infrastructure Development and Financing in the Russian Far East

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### Abstract

*The importance of the Asia-Pacific region has increased significantly for the Russian economy. The Russian government's Far East Development Program has shown the way towards infrastructure development in the Far East. Given the regional characteristics of the Far East, it is important to take a flexible approach when selecting priority projects of vital importance and of high utility value, and when utilizing government-led investment to develop transportation infrastructure, while at the same time, proactively inviting private investors when bankable infrastructure projects arise. From such a perspective, JBIC intends to contribute to the "Win-Win" Far East development through the Japan-Russia Investment Platform with RDIF and through partnership with FEDF under the business cooperation. Considering the further deepening relations among North East Asian countries, we see huge potential for growth when viewing the Japan Sea Rim Economic Subregion as a single economic bloc. In order to promote such regional economic development, a bold and flexible way of thinking is needed to take a view of Northeast Asia, including the Russian Far East, as a "plane" from the perspective of international logistics.*

Keywords: Russian Far East, Infrastructure, Far East Development Program, Japan-Russia Investment Platform, Japan Sea Rim Economic Subregion

### Introduction

A member of Asia with a wide expanse of national land, Russia has been boosting exports, mainly that of oil, natural gas, and other energy resources, to the Asia-Pacific region. Also, the importance of the Asia-Pacific region including China, which has now become Russia's largest trading partner, as well as Japan and South Korea, has increased significantly for the Russian economy.

While the Russian Far East region<sup>1</sup> (hereinafter referred to as the "Far East") is located in a corner of the Asia-Pacific region and accounts for over a third (36.4%) of Russia's land area, its share in the country's gross domestic product (GDP) stands just around 5-6% and its population only at 4.5%, having been left out of Russia's social and economic development for a long time.

Since the inauguration of the government of President Vladimir Putin, the phrase "Leave Europe, Enter Asia" has been heard among Russian intellectuals. "Leave Europe, Enter Asia" is the phrase wording emblematic of the Putin administration's shift in the emphasis of policy emphasis from Europe to the Asia-Pacific region. The Russian government took the opportunity of hosting the Asia-Pacific Economic Cooperation (APEC) summit in Vladivostok in September 2012 to put more effort than before into the development of the Far East. Behind this is nothing less than Russia's political and economic intention to benefit from take in the "dynamism" of the Asia-Pacific region, with remarkable development for Russia's economic growth with the Far East serving as a gateway. With the economies of Europe, hitherto the cornerstone of its external economic relations, remaining sluggish in the wake of the Eurozone crisis, Russia wants to find a way out by searching for new opportunities in the Asia-Pacific region. In the Presidential Address to the Federal Assembly of the Russian Federation in December 2013, President Putin referred to

the importance of developing relations with the Asia-Pacific region.

Against this backdrop, Prime Minister Shinzo Abe made an official visit to Russia in April 2013 for a summit meeting with President Putin, the first time in 10 years a Japanese prime minister had visited the country. At the summit, the two leaders agreed to promote cooperation for the development of the Far East, including the establishment of an investment platform by the Japan Bank for International Cooperation (hereinafter referred to as “JBIC”) and the Russian Direct Investment Fund (RDIF) /Vnesheconombank (VEB). Despite the lingering territorial issue, if Japan and Russia, strengthening ties under the strong leadership of both leaders, cooperate to push forward with the development of energy resources and infrastructure and the fostering of industries in the Russian Far East, it can be expected that the Russian Far East will be incorporated into the economic growth of the Asia-Pacific region, as well as that progress will be made toward the Japan Sea Rim Economic Subregion comprising of Japan’s Sea area of Japan, northeastern China, the Korean Peninsula, and the Russian Far East.

This article discusses the rise of Russia, a major power in the Asia-Pacific region, as well as progress in the development of the Far East. In Chapter 1, an overview of the latest political and economic developments in Russia and the importance of the Far East are presented. Chapter 2 focuses on infrastructure development in the Far East and discusses the current status and future outlook of infrastructure development. Japanese cooperation and efforts for the promotion of investment in the Russian Far East are addressed in Chapters 3 and 4, and the future outlook for the “Win-Win” Far East development for both Japan and Russia is presented in the Conclusion.

## **1. The Current State of Russia’s Government and Economy and the Importance of Development of the Far East**

### **1.1. The Current State of Russia’s Government and Economy**

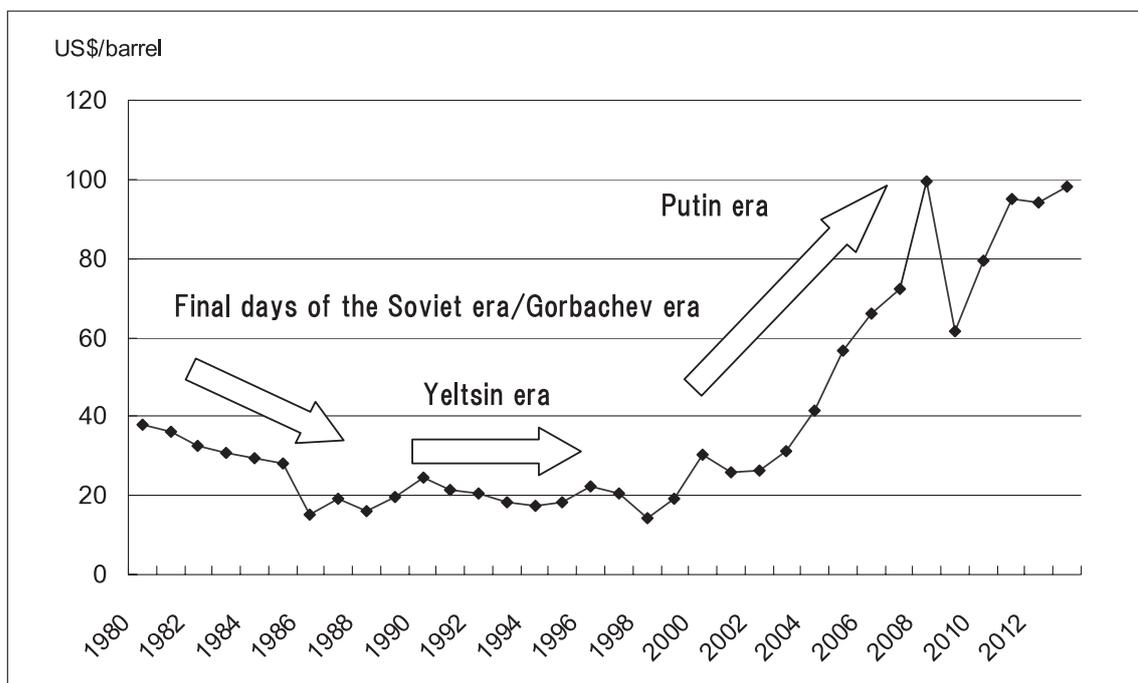
#### **1.1.1. The Strong Putin Government**

The first Putin government launched in 2000 came up with the “Great Power policy” to seek the revival of Russia. For this reason, the first thing Putin did was oppress the influence-peddling new conglomerates (oligarch), and he then created the “federal district presidential representative system”, to place regional powers across Russia under his control. The “federal district presidential representative system” was a political mechanism aimed to realize a pyramidal grip of power in order to receive and carry out orders from the central government carried through, and represented a major shift from the decentralization of power advocated by former President Boris Yeltsin. Chechen, Tatarstan, and some other ethnic republics in the Russian Federation fiercely rebelled against President Putin’s initiative. However, in the face of overwhelming military force, the turmoil eventually calmed down, and many Russians supported the restoration of order after the resulting confusion from the aftermath of the collapse of the Soviet Union, and also supported social stability under Putin.

Another important factor behind the popular support for the first Putin government was that higher crude oil prices benefited the Russian economy and result in dramatically raising the standard of living of Russian people (Figure 1). Crude oil prices began falling in the final days of the Soviet era, breaking below US\$20 per barrel. Crude oil prices remained low during the Yeltsin era, but started its sharp ascent around 2000 when Putin came to power. Russia took

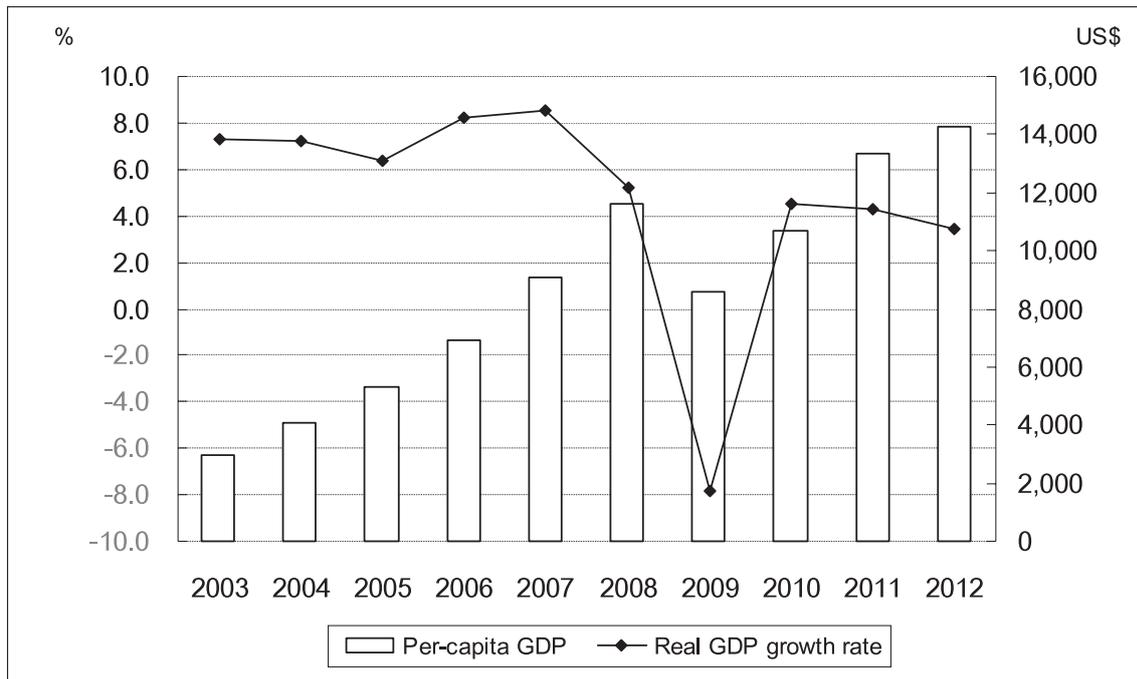
advantage of a massive inflow of oil money to accumulate foreign currencies, becoming the world's third largest holder of foreign exchange reserves after China and Japan. As the reins of government was handed over to Dmitry Medvedev when crude oil prices fell sharply in the wake of the Lehman Shock of 2008, Putin was not held responsible for Russia's dismal economic performance following the economic crisis, and crude oil prices was again on an upward trend by the time of the inauguration of the second Putin government in May 2012. While allegations of election fraud by the ruling party United Russia emerged in the December 2011 State Duma election, the share of the vote stood at 63.6% at the time of the inauguration of the second Putin government, an indication of the continued popular support for the strong leadership of the Putin government.

**Figure 1: Changes in Crude Oil Prices and the Governments in Russia**



Source: IMF Statistics

The Russian economy, heavily dependent on exports of oil, natural gas, and other energy resources, was dealt a heavy blow by the global financial crisis triggered by the Lehman Shock, with its GDP growth rate in 2009 slumping to negative 7.8%. However, the economy subsequently recovered, and Russia's real GDP showed a stable 3.4% growth in 2012, helped by, among others, crude oil prices remaining high during the first half of that year (Figure 2). The real GDP growth rate in 2013 is expected to slow down from 2012, with the Ministry of Economic Development and Trade estimating growth at 1.4% (as of December 2013). An international organization estimates that Russia's per-capita GDP in 2012 was a steady US\$14,247.

**Figure 2: Per-Capita GDP and Real GDP Growth Rate**

Source: JETRO

### 1.1.2. Slack Resources Trade with the “West,” Expectations on the “East”

While Russia has achieved its economic growth so far by exporting resources to the “West,” including Europe, the shale gas revolution in the United States and other parts of the world is recently giving Russia a new headache, and the European Union (EU), former republics of the Soviet Union, and Eastern European countries that relied on Russia for the supply of energy have heightened their bargaining power and started playing tough with Russia. It is still fresh in our minds that Ukrainian President Viktor Yanukovich surprised Russia by canceling a visit to Moscow in December 2012 for negotiations on import prices of Russian natural gas. Ukraine’s international balance of payments has deteriorated rapidly because of sharp natural gas price hikes by Russia, and declines in spot prices of natural gas that gave rise to the likelihood of Ukraine being able to import natural gas from other sources were believed to have prompted Yanukovich’s cancellation of the planned trip to Russia. Historically, the largest export markets for Russia are Germany and other European countries, which take about half of exports from Russia. Following the shale gas revolution, however, Russia is expected to face even tougher price negotiations for its Europe-bound exports of resources, and Russia was also forced to suspend its plans to export liquefied natural gas (LNG) (Shtokman LNG, etc.) to North America. For these reasons, President Putin has expressly put forward the “Look East policy,” planning to boost exports of resources to China and other Asian countries with growth potential on top of Japan and South Korea, by laying pipelines going through Khabarovsk and Vladivostok in the Far East, and also expecting an expanded inflow of technologies and funds from Asian countries.

## 1.2. Russia's Asia-Pacific Strategy

### 1.2.1. Growing Asia

At a time when the U.S.-dominated “single polar system” has taken a step backward, and the framework of the Group of Eight major industrial countries (G8) is no longer functioning effectively, multilateral organizations and regional organizations in the economic field have newly come forward, with G20 (summit meetings of 20 major countries and areas) and BRICS (summit meetings of the five countries of Brazil, Russia, India, China, and South Africa). Nothing can be decided by G8 (summit meetings of eight major industrial countries), and in particular it has been often pointed out that the framework of G8, which excludes China with the world's second-largest GDP, is now behind the times. Looking at the GDP of the G20 members by region, North America accounts for about US\$16.8 trillion (2011), Asia about US\$16.7 trillion (2011), and Europe about US\$11.2 trillion (2011). When the GDP of Russia, Turkey, and Saudi Arabia is added to the above figures as Asian countries in a broad sense, the combined GDP for Asia comes to US\$19.9 trillion, far larger than the North American GDP, giving the Asian economic bloc a nonnegligible presence.

According to a survey by Goldman Sachs Group Inc., the GDP of the four BRICS countries other than South Africa is expected to overtake that of G6 (the United States, Britain, France, Germany, Italy, and Japan) by 2039, and China's GDP is likely to surpass that of the United States by 2041. The same survey results predict that the world's six largest economic blocs in 2050 will be (1) China, (2) the United States, (3) India, (4) Japan, (5) Brazil, and (6) Russia, with European countries disappearing from the six largest economic blocs. The geographical classification of the anticipated six largest economic blocs in 2050 shows that China, India, Japan, and Russia are all located in Asia or Eurasia, making Asia or Eurasia the center of the world economy around the mid-21st century.

### 1.2.2. Moves for the Far East Development and the Foray into the Asia-Pacific region

Russia's diplomacy has thus far revolved around the “West,” and even through Moscow regards the Asia-Pacific region as important, the West has remained the cornerstone of its foreign policy. Amid the sluggish growth of European countries in the wake of the global financial crisis, however, the Putin government has made a strategic shift to the “East” in search of the engine of Russia's future growth in Asia, making clear its stance of accelerating the Far East development in order to take in the economic growth of the Asia-Pacific region.

Since former Soviet Communist Party General Secretary Mikhail Gorbachev's “Vladivostok Speech” in 1986, in which he unveiled plans to turn Vladivostok, then the closed city, into a “window” for exchanges with the Asia-Pacific region, the momentum begun for economic cooperation with the Asia-Pacific region through the Far East, and following the inauguration of the first Putin government in 2000, Russia made a full-fledged shift to the East and joined multilateral organizations in Asia one after another. Particularly in 2000, the year when the first Putin government was launched, President Putin chose the East Asia as the destination for his first diplomatic tour and visited China, North Korea, and Japan. The Shanghai Cooperation Organization (SCO), which later developed into a security mechanism for the Central Asian region, was also created in 2000. In 2003, Russia also joined the Six-Party Talks on the Korean

Peninsula to discuss North Korea's nuclear development, and at the Economic Leaders' Meeting of the Asia-Pacific Economic Cooperation (APEC) held in Sydney in 2007, Russia expressed its intention to host the APEC summit in Vladivostok. With its accession to the Asia-Europe Meeting in 2010 and participation in the East Asia Summit in 2011, Russia has now been numbered among the members of all of Asia's key forums, leading to its hosting of the APEC summit in Vladivostok in 2012. Under the leadership of President Putin, Russia is finally shifting into high gear with its development strategy for long-term development of the Far East while strengthening economic relations with fast-growing Asia-Pacific countries.

### 1.2.3. The Geopolitical Importance of the Japan Sea Rim Economic Subregion

The Russia Far East is located adjacent to China, but the Primorsky Region, Khabarovsk Region, Amur Oblast, and Jewish Autonomous Oblast are the only areas that actually border with China. Given that Amur Oblast and Jewish Autonomous Oblast have no access to the sea, their dependence on China inevitably increase. Looking at the situation from China as well, of the three northeastern provinces (Liaoning Province, Jilin Province, and Heilongjiang Province), only Liaoning Province has access to the sea, and the three provinces' increased exchanges with the Russian Far East appear to be only a natural development geographically.

Furthermore, the Russian Far East is connected to North Korea by a railway extending from Khasan station in the southernmost part of the Primorsky Region to Rajin port in North Korea across the Tumen River, which is positioned as part of a plan to link the Trans-Siberian Railway to the Trans-Korean Railroad. Russia changed the rail gauge to Rajin port into a mixed gauge of standard gauge and broad gauge, and conducted a test run in October 2011. The mutual railway extension into Busan, South Korea, is on the drawing board for the future.

In a similar manner with the railway, a project is under way to construct a natural gas pipeline that runs through the Korean Peninsula, which is supposed to be mainly used to carry natural gas from Russia to South Korea.

In addition, there is a plan to construct a power transmission line to supply electricity generated in Russia to North Korea, which is plagued with power shortages.

Against these backgrounds, plans have been under discussion for many years for cross-border infrastructure projects (Tumen River development, distribution systems, construction of a pipeline to carry natural gas from Russia to North and South Korea, etc.) and the establishment of regional development banks by the Japanese, Chinese, and South Korean governments, or a Northeast Asia Bank for Cooperation and Development to support infrastructure projects that utilize private-sector resources involving Japanese, Chinese, and South Korean companies. While there should be no objections towards initiatives for the development of the Japan Sea Rim Economic Subregion from an economic point of view, the recent heightening of political tensions between Japan and China and between Japan and South Korea is presently keeping the momentum from rising for the establishment of such a new regional financial institution any time soon. Therefore, it is important to select quality projects first. If the coordination among countries involved requires time, it may be a good idea to make use of a framework of dialogue like the Japan-Russia investment platform described in Chapter 4.

### 1.3. The Significance of the Far East Development

#### 1.3.1. Population Outflows from the Far East

For Russia, while the advance into the Asia-Pacific region and the development of the Japan Sea Rim Economic Subregion are important elements of the Far East development, controlling population outflows from the Far East is also an important objective and means for the Far East development.

With natural resources buried in abundance under a broad stretch of land from East Siberia (east of Lake Baikal) to the Primorsky Region, the Russian Far East has developed itself as an export base for resources. In the wake of the economic turmoil after the breakup of the former Soviet Union, and the abolition of various preferential measures accorded to residents in the Far East, people have been moving out of the Far East to the western part of Russia, where the climate is mild and infrastructure has been relatively developed, or to overseas. Over the past 20 years (1990-2009), the population of the Far Eastern Federal District declined roughly 20% from some 8 million to 6.5 million, and the population outflow does not appear to be abating even after the commencement of the Far East development.

In inverse proportion to the population outflow, foreign workers have been on the increase. While not many Russians support the acceptance of foreign workers, Chinese workers are moving into the Russian Far East across the China-Russia borders, advancing into a variety of fields, including house building and road construction.

The population of China's Heilongjiang Province neighboring the Russian Far East across Amur River and other borders is some 38 million (2010), about six times as large as the 6.5 million people in the Russian Far East. The situation where the entry of Chinese workers into the Russian Far East may outnumber Russian residents with their expanding living quarters, has been the cause of alarm for Russia, spawning a sense of crisis not only from political and economic aspects, but also from the standpoint of national security. For Russia, the Far East development is no longer just a policy challenge based solely on the positive motivation to take in the vitality of the Asia-Pacific region, but rather a compelling policy challenge against the backdrop of the declining population and an overwhelming demographic pressure from neighboring China as well as the political, economic and security threats arising from them.

#### 1.3.2. The Strategic Vision for the Far East Development

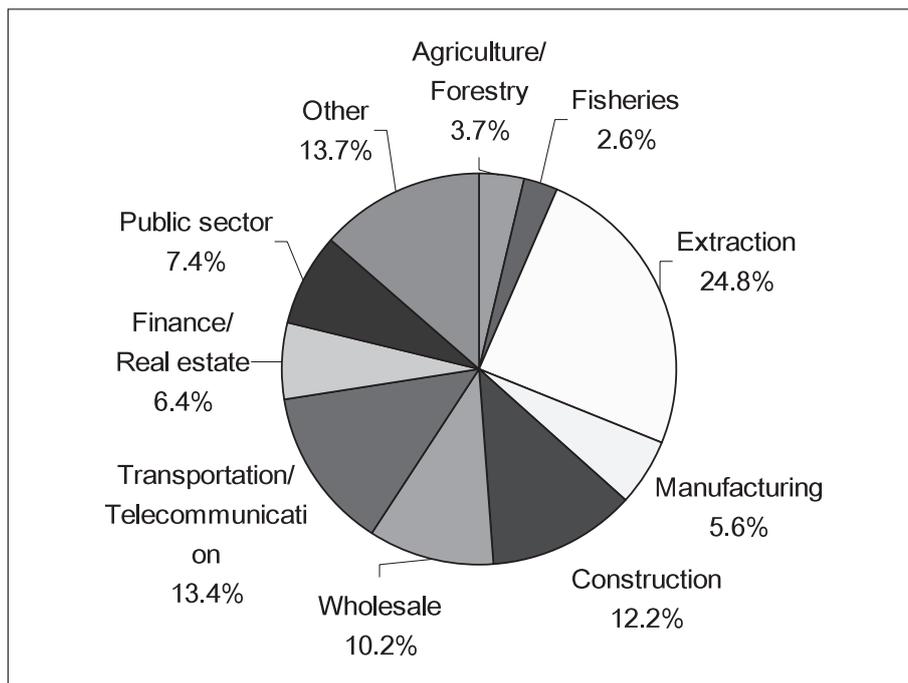
The Putin government's intention is to leverage the Far East development to redress the gaps with the central parts of Russia, raise the quality of life of residents, and promote the settlement of Russians without succumbing to the demographic pressure from China, in order to put the brakes on the outflow of population from the Far East. The government has a sense of crisis that unless the population outflow is stemmed, the Far East's economic growth would slow down and the economic disparity with the central parts of Russia would further widen.

Under these circumstances, the Putin government aims for the revival and fostering of manufacturing, not limited to infrastructure development, and seeks to turn the Far East into the point d'appui as the gateway to the Asia-Pacific region as the core part of the strategic vision for the Far East development.

As shown in Figure 3, the extraction of resources accounts for a quarter of the Far East's

gross regional production (GRP), with the manufacturing industry having only a meager 5.6% share (2010). But the Putin government is focusing on the manufacturing industry, as represented by automakers, by introducing tax breaks such as the exemption of import duties on certain parts for manufacturers setting up local production operations, developing an idea to turn Vladivostok into the “auto production base of the East.” The government also finds it necessary to tackle the development of distribution infrastructure, such as roads, railways and ports, collectively being the keys to transportation to the Asia-Pacific region, which will be the main market for the Russian Far East.

**Figure 3: Composition of the Russian Far East’s Gross Regional Product**



Source: Federal State Statistics Service

The development of the Far East, not only as a supply center of resources but also as a regional economy of growing importance as a manufacturing base, brings huge advantages to Japan as well as leading to stronger Japan-Russia relations through a successful development of the Far East. Also, the stability of the region through the Far East’s enhanced economic strength is deemed desirable from the perspectives of politics and security. Ongoing discussions on further Russo-Japanese cooperation in the Far East and Siberia following the Japan-Russia summit in April 2013 represent efforts in the right direction, which are expected to contribute to further strengthening relations between the two countries. From the standpoint of the Japan Sea Rim Economic Subregion, an idea to view the Subregion as a “plane” or a single economic bloc, is also of importance. For the Japan Sea Rim Economic Subregion, it is hoped that the Far East economy, which hitherto has not had much of a presence other than the supply of resources, will become revitalized and strengthen ties with the economies of Japan, China, and South Korea with trade and investment, with its enhanced presence raising the overall level of the Japan Sea Rim Economic Subregion, and leading to the optimization of international division of labor.

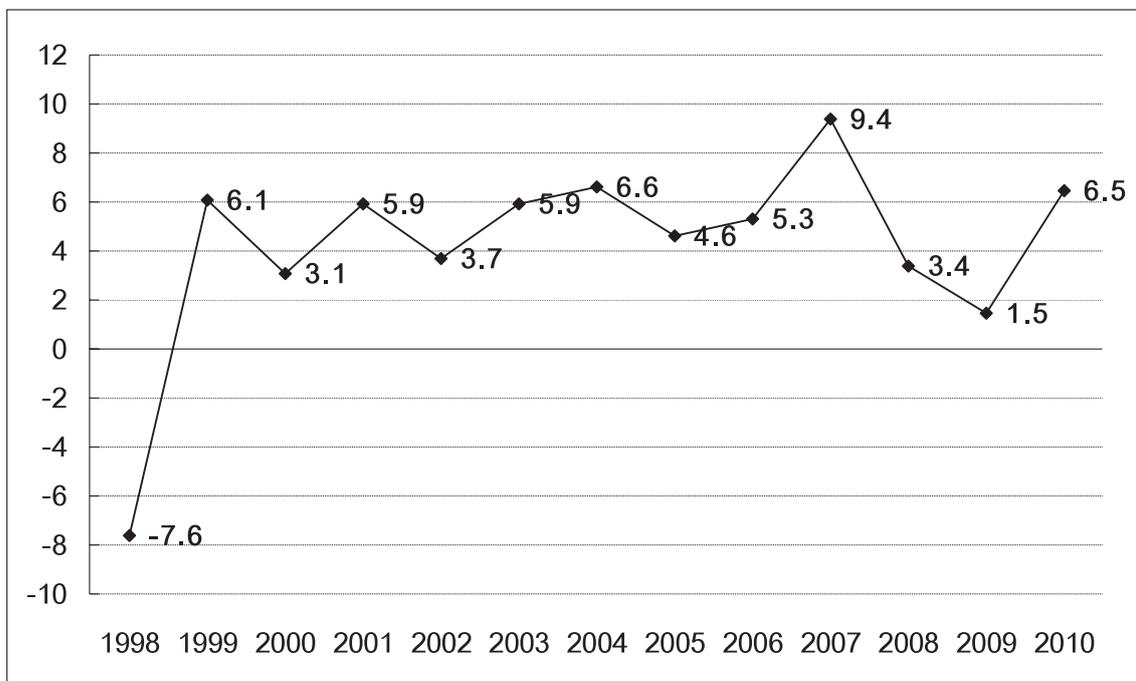
## 2. The Current State and Future Outlook of Infrastructure Development in the Russian Far East

### 2.1. The Economic Overview of the Russian Far East and the Current State of Infrastructure Development

#### 2.1.1. The Economic Overview of the Russian Far East

As shown in Figure 4, the Russian Far East's GRP in 2010 stood at 2,103.4 billion rubles (approximately ¥5,679.2 billion), an increase of 6.5% over 2009, with the positive growth exceeding the 4.5% expansion of the overall Russian economy. While Russia slipped into negative growth in 2009 in the aftermath of the global financial crisis, the Far East has marked the positive growth for 12 consecutive years since 1999.

**Figure 4: Economic Growth Rate of the Russian Far East**



Source: Federal State Statistics Service

In addition to the continued robustness of industries related to the extraction of resources, production of the manufacturing industry shot up 22.1%, due primarily to the commencement of automobile production and increased output of aircraft, making a significant contribution to the GRP growth.

On the other hand, foreign investment remained low. Foreign direct investment in the Russian Far East, which amounted to only hundreds of millions of U.S. dollars until 2002, rose sharply to US\$3.0 billion in 2004 and to US\$4.0 billion in 2006, which were mainly made up of funds invested in oil and natural gas development projects in Sakhalin, but plummeted to US\$1.2 billion in 2010.

Russia, not limited to the Far East, actively introduced foreign capital since the collapse

of the Soviet Union, but Russian companies, supported by public investment by the central government, did not try to take in foreign capital but rather distanced themselves from foreign capital. When the economy is booming, large-scale public investments contribute to the revitalization of regional economies. When the economy sputters, however, the burden of the Far East development, including infrastructure development, is highly likely to weigh heavily.

## 2.2. The Far East Development Program

### 2.2.1. Transition in the Far East Development Program

Following the inauguration of the first Putin government in 2000, the “Russian Federation's Special Economic and Social Development Program for the Far East and Zabaikal Region for the period 1996 - 2005 and 2010,” a revised version of the “Special Federal Program for the Economic and Social Development of the Far East and Zabaikal Region Program for the period 1996 - 2005” formulated in 1996, was approved, but the program had little impact on the development of the Far East as expenditures from the federal budget was kept low. Subsequently, with sharp rises in crude oil prices bringing ample funds into the federal coffers, some 75% of the budget for the “Economic and Social Development of the Far East and Trans-Baikal for the Period to 2013,” approved in November 2007 after another revision, was to be funded by the federal government, signaling the federal government’s enthusiasm for the Far East development.

Meanwhile, in December 2009, the federal government approved the “Strategy for the Socio-Economic Development of the Far East and Baikal Region to 2025,” setting out long-term development plans for federal districts. The primary objective of the strategy was to raise the level of socio-economic development in the Far East and Zabaikal region to the average national level, thereby promoting the settlement of residents there. The strategy reflected the Russian government’s strong intent to solve the problem of population outflows from the Far East.

Furthermore, in April 2013, the Russian government approved an ambitious federal state program, “Socio-Economic Development of the Far East and Baikal Region,” designed to boost GRP of the Far East and Baikal region 2.2 times, increase industrial production by 53% and expand exports three times, respectively, from the 2011 levels by 2025. The program is outlined in Table 1.

The program was put together in a short period of three months by the Ministry for Development of Russian Far East under President Putin’s instructions. While inheriting a variety of existing programs described above, it has been developed presumably as a comprehensive development plan for the Far East and Baikal region. The program consists of 12 subprograms put together for such individual themes as transportation infrastructure and electricity infrastructure for the Far East and Baikal region, as well as that of two federal objective programs, “Economic and Social Development of the Far East and Baikal Region for the Period to 2018,” and “Socio-Economic Development of the Kuril Islands (Sakhalin Oblast) for the period 2007-2015” (hereinafter referred to as the “Far East Development Program”). The program includes a list of hundreds of concrete projects, their budgets and the timing of implementation, etc., conveying the Putin government’s strong message that the “Far East development is a top priority for Russia.”

**Table 1: Overview of the Far East Development Program**

Competent authority	Ministry for Development of Russian Far East
Aggregate investment	Approximately 10.7 trillion rubles
Federal government	Approximately 3.8 trillion rubles
Regional governments	Approximately 350 billion rubles
Private sector	Approximately 6.5 trillion rubles
Period	2014-2025
Coverage	Federal districts, Irkutsk Oblast, Buryatia Republic, Zabaikal Region
Composition	12 subprograms and 2 federal objective programs
Major projects	Development of the Trans-Siberian Railway and the Baikal-Amur Mainline (BAM) Railway, development of regional airports, construction of LNG plants, etc.

Sources: Mitsui Global Strategic Studies Institute, etc.

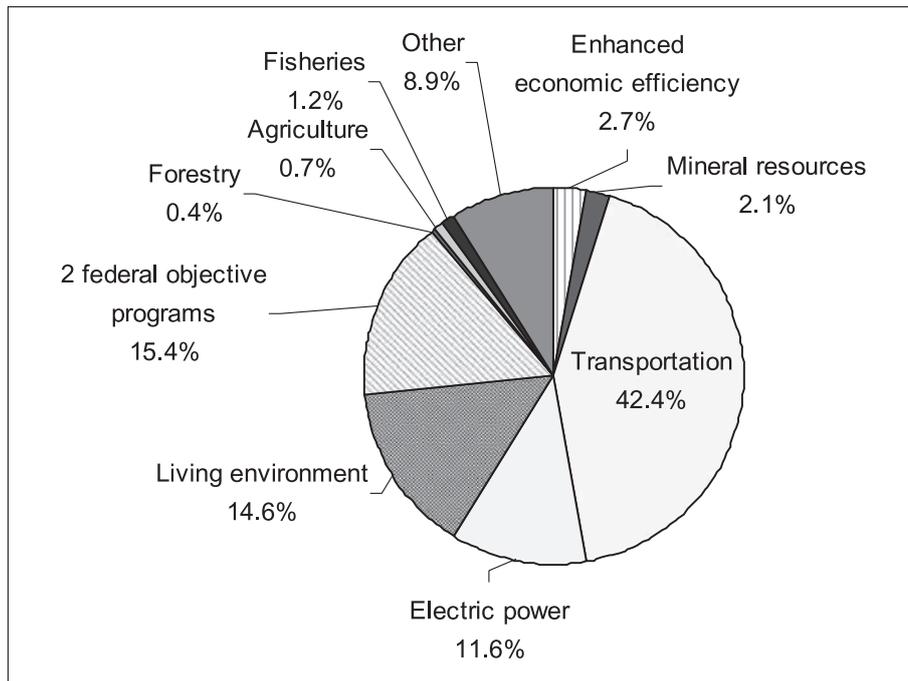
### 2.2.2. The Current State of Infrastructure Development in the Russian Far East

Judging from the Far East and Baikal Region Socio-Economic Development, the Russian government seems to be placing emphasis on the development of transportation infrastructure (transit and physical distribution), and the development of electrical infrastructure in order to leverage the region's geographically easy access to the Asia-Pacific region and the advantage of having abundant resources, including crude oil, natural gas, and metal resources.

Aggregate investment in the transport infrastructure reaches 1.7 trillion rubles as the sector is considered to be the largest obstacle to the development of the Far East and Baikal region. While some 850 billion rubles are allocated to the overhaul and modernization of the Trans-Siberian Railway and the Baikal-Amur Mainline (BAM) Railway, approximately 1.6 trillion rubles of federal budgets are earmarked for the planned development and expansion of roads to inland regions, including the road connecting Yakutsk and Magadan, ports, and regional airports. An expansion of transport and traffic networks is expected to further enhance the presence of the Far East and Baikal region as a shipping terminal linking Asia and Europe.

In the electricity infrastructure sector, construction and renovation of power plants and an expansion of power transmission lines are under consideration, with over 400 billion rubles of federal budgets allocated.

In addition, Russia is planning to complete a natural gas pipeline, called the SKV Pipeline, from Sakhalin to Vladivostok via Khabarovsk, and a crude oil pipeline, called the Pacific Pipeline, seeking to develop Vladivostok as a collection center of crude oil and natural gas by developing petrochemical and gas chemical industries at the terminals of these pipelines.

**Figure 5: Breakdown of Federal Budgets for the Far East Development Program**

Source: Prepared by the author based on materials of the Institute for Russian & NIS Economic Studies

### 2.2.3. Challenges in Implementing the Far East Development Program

While the Far East Development Program should be appreciated for signaling the medium- and long-term direction of the Far East development and the government's resolve to carry through with it, several challenges have been pointed out.

The first concerns the organizational structure for promoting the Far East development. The Ministry for Development of Russian Far East was created in May 2012 and took charge of putting together the above-mentioned "Far East and Baikal Region Socio-Economic Development" program as a command center for the Far East development. However, Minister for Development of Russian Far East, Victor I. Ishaev, was dismissed abruptly in September 2013, and Alexander Galushka was subsequently appointed as his successor. Galushka, an experienced consultant in the private sector, reportedly intends to clarify the areas covered by the federal government and the private sector and their respective roles in order to make the Far East Development Program into a more realistic one. In October 2013, immediately after the appointment of the new minister, a government committee on socio-economic development matters in the Far East, which met in Khabarovsk, made a positive move to consolidate the functions and administrative powers concerning the Far East development with the Ministry for Development of Russian Far East<sup>2</sup>, but whether the Ministry for Development of Russian Far East can perform its function sufficiently going forward remains to be seen. Furthermore, an idea is said to be still contemplated within the Russian government to establish an East Siberia and Far East Development Corporation, as a propulsory machinery for the Far East development reporting directly to the President to implement important regional development projects. At any rate, in order to lead the Far East development, the existence of a powerful organization bestowed with both the authority to decide on business development and the authority to use budgets would

be necessary.

The second challenging task is the prioritization of projects. The list of projects in the Far East Development Program includes the electric power sector, the transportation sector, such as railways, ports, airports, and roads, the resources sector, the production sector, including manufacturing and agriculture, and even a space station. Among projects in the extensive list, which are the most efficient and can be expected to yield large effects to meet such policy objectives as the urgently required enhancement of connectivity within the region and to the Japan Sea Rim Economic Subregion, and the fostering of industries and measures to counter the decline of population? Given that funding for the Far East development is not limitless, the selection of priority projects would be imperative. It is also necessary to decide on the ordering of the priority of projects not only in terms of profitability, but also from a social policy perspective.

The third challenge is in attracting investors and business operators from home and abroad. While the Far East development is being undertaken with the federal government's large-scale investment and political initiative, it is being pointed out that funds currently invested come all but from the federal government's budgets and government-affiliated enterprises, and private-sector investment is going to other regions in Russia or overseas. In addition, as the Far East has not actively tried to introduce foreign capital previously, the investment climate has not improved, with complicated licensing procedures left unattended, requiring the Russian government to take institutional and other measures to invite private-sector investment. Furthermore, on top of measures to improve the investment climate, efforts to discover and organize projects with high feasibility are gaining in importance in order to attract the interest of private-sector investors and business operators (See Chapter 4 for the "Japan-Russia Investment Platform," a framework of cooperation between Japan and Russia for that purpose).

The fourth challenge is financing, which is discussed in the following section.

### 2.3. Financing for Infrastructure Development in the Far East

An aggregate amount of investment required to implement the Far East Development Program is estimated to reach 10.7 trillion rubles by 2025. The federal government and regional governments together cover a little less than 40% of the total amount, and over 60% is expected to come from private-sector investment.

In the Far East Development Program, the development under the public-private partnership is envisaged, with the infrastructure sector, such as transportation and electric power, designated for the priority allocation of federal funding. In particular, transportation is recognized as the biggest factor hampering the development of the Russian Far East, and 1.6 trillion rubles (or over 40%) of the federal budgets of 3.8 trillion rubles are earmarked for the transportation field, including the renovation of Trans-Siberian Railway and BAM Railway. Since it is difficult for private-sector business operators or private-sector financial institutions to assume commercial risks in the development of transportation infrastructure given the lack of guaranteed usage in depopulated regions like the Far East, the easy reliance on the "private sector" could result in no progress in infrastructure projects. Considering this, it is commendable that the federal government has made clear its policy to take the initiative in the development of transportation infrastructure.

Given Japan's postwar experiences, instead of developing infrastructure with an idea

of gaining profits from projects concerned, infrastructure development should be pushed forward with the use of large-scale investment under the governmental budget and government guarantees, with the idea of economic revitalization through the enhanced convenience of transportation as a result of infrastructure development. This way of undertaking infrastructure projects is recommended not only for Russia, but also for infrastructure projects in other emerging economies. Backed by long years of experience in supporting projects in emerging economies, in recent years JBIC has been holding policy dialogues and providing advice on a continuing basis on measures to promote infrastructure projects under public-private partnerships in Indonesia and Viet Nam. JBIC hopes to provide “software” cooperation depending on Russia’s needs, by making use of such frameworks as the Japan-Russia Investment Platform (described below) for infrastructure development in the Russian Far East as well.

### **3. Japan’s Cooperation for the Far East Development**

#### **3.1. Past Economic Cooperation in the Far East**

Japan has so far been involved in the development of resources in the Russian Far East, including such flagship projects as the Sakhalin 1 Project (the project cost is estimated at US\$12 billion. JOGMEC and other entities have acquired some interests in the project) and the Sakhalin 2 Project (the project cost is estimated at US\$20 billion. Mitsui and Co., Mitsubishi Corp. and other entities have acquired some interests in the project). However, investment from Japan is now beginning to flow into fields other than resources. As described in Section 3 of Chapter 1, as the Putin government positions the revival and fostering of the manufacturing industries in the Far East as a high-profile challenge, Japanese and other automakers set up production bases and started operations there. More specifically, in Vladivostok, where used Japanese vehicles command a market share of over 90%, Russian automaker Sollers moved in and started assembling South Korean-brand passenger cars in 2010. Mazda Motor Corp. commenced production in October 2012, and then Sollers-Bussan, a joint venture between Mitsui and Co. and Sollers started producing Toyota vehicles in February 2013. The Russian government is also proactively supporting the invitation of manufacturers there by offering preferential taxation measures, including zero import duties for some parts and components. Sojitz Corp. and Kawasaki Heavy Industries, Ltd. delivered cogeneration equipment, a power generation system to provide both heat and electricity said to be in strong demand in cold regions, to a federal university on Russky Island, the venue of the APEC summit. Such business efforts based on regional characteristics are also worthy of attention.

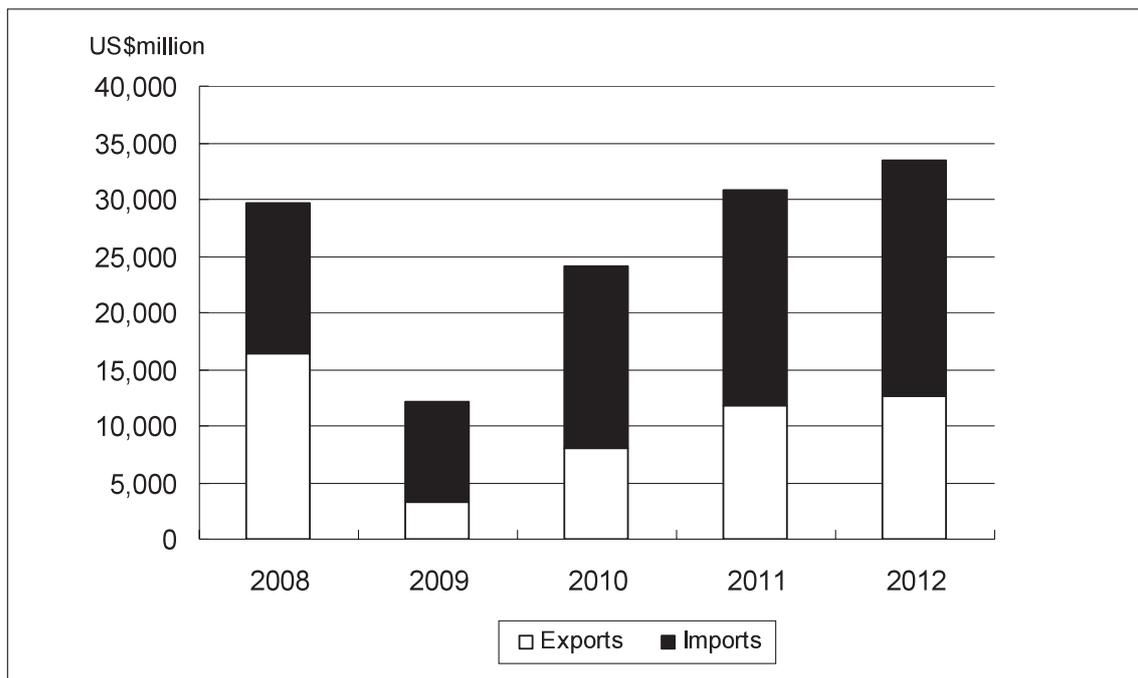
#### **3.2. Progress in Japan-Russia Cooperation in the Far East Development**

The visit to Kunashir Island by then President Medvedev in November 2010 threw Japan-Russia relations into a negative state temporarily, but following the Great East Japan Earthquake of March 2011, the dialogue between the two countries resumed after prompt proposals by the Russian government, particularly then Prime Minister Putin, for humanitarian assistance and energy cooperation. Furthermore, the fact that the Russian government has embarked in earnest on the development of the Russian Far East and its Asia-Pacific strategy after the APEC summit held in Vladivostok in September 2012, is having a positive impact on Japan-Russia relations.

Particularly after the inauguration of the Japanese government of Prime Minister Abe, Japan and Russia have both come to recognize the importance of the Far East development. When Prime Minister Abe visited Russia in April 2013, the two countries issued a joint statement on the Japan-Russia partnership, and the Japan-Russia summit meetings were held multiple times in a single year.

As shown in Figure 6, Russo-Japanese economic relations recovered from the doldrums caused by the economic crisis in 2009. In 2012, Japan's exports to Russia rose 7.1% over the previous year to some US\$12.6 billion, and its imports from Russia also increased 9.9% to some US\$20.8 billion, setting a record high in terms of the dollar-quoted value of bilateral trade.

**Figure 6: Trends of Japan-Russia Trade**



Source: Ministry of Finance Japan

Prime Minister Medvedev's recent visit to Kunashir Island following his earlier visit in 2010 poured cold water on Japan-Russia relations yet again, but it should be noted that the bilateral dialogue is continuing despite this incident. It is hoped that Japan and Russia will continue to enhance the dimension of cooperation as strategic partners going forward.

**Table 2: Recent Developments Related to the Far East Development**

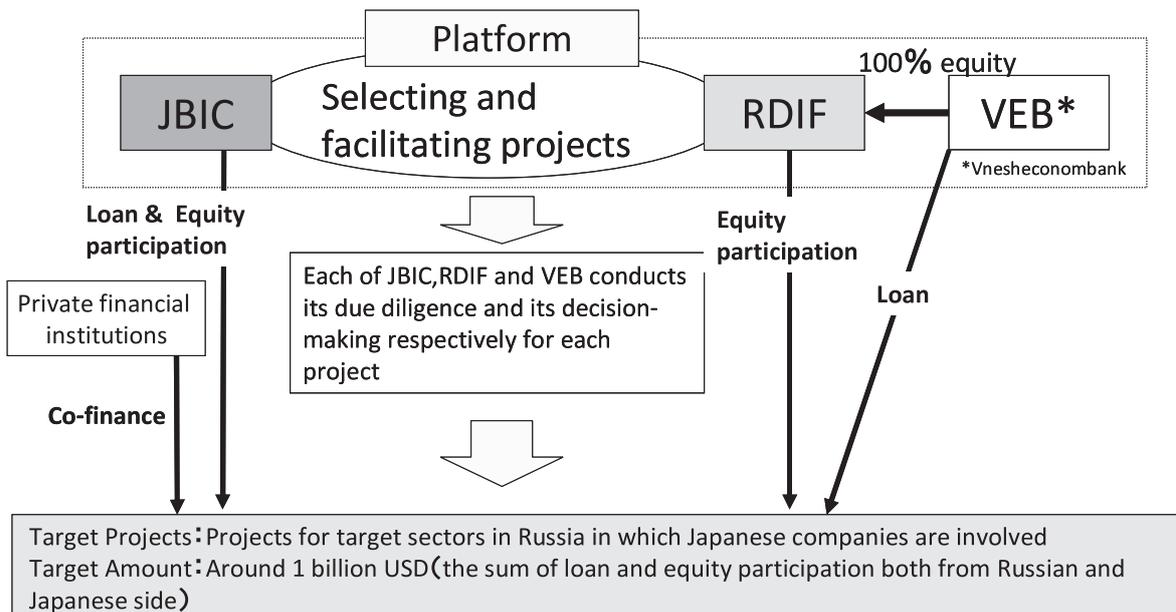
2011	
August	The Russia-North Korea summit was held; a natural gas pipeline between Russia and South Korea via North Korea was discussed.
October	A test run of the railway between Rajin (North Korea) and Khasan (Russia) started.
November	At the Russia-South Korea summit held in Saint Petersburg, the top leaders discussed a natural gas pipeline running through North Korea.
2012	
May	The Ministry for Development of Russian Far East was established. Victor I. Ishaev, Presidential Representative in the Far Eastern Federal District, was appointed as the first minister.
July	Prime Minister Medvedev visited Kunashir Island.
September	The APEC summit was held in Vladivostok.
2013	
April	The federal state program, "Far East and Baikal Region Socio-Economic Development," was adopted. The Japan-Russia summit was held (in Moscow, Russia).
June	The Japan-Russia summit was held in (in Lough Erne, Northern Ireland, UK).
September	Victor I. Ishaev, Presidential Representative in the Far Eastern Federal District and Minister for Development of Russian Far East, was dismissed. Yuri Trutnev was appointed as Presidential Representative in the Far Eastern Federal District and Deputy Prime Minister, and Alexander Galushka as Minister for Development of Russian Far East.
October	The Japan-Russia summit was held (in Bali, Indonesia).

Source: JETRO

## 4. For Promotion of Japan-Russia Joint Investment

### 4.1. Japan-Russia Investment Platform

On the occasion of the Japan-Russia summit in April 2013, JBIC concluded a memorandum of understanding on the establishment of the Japan-Russia Investment Platform with Vnesheconombank<sup>3</sup> (VEB) and the Russian Direct Investment Fund<sup>4</sup> (RDIF). The Japan-Russia Investment Platform is a framework of joint support by JBIC, RDIF and VEB for projects in which Japanese companies participate in order to expand Japanese companies' business operations and technological presence in Russia, including the Far East. The investment platform is expected to be utilized for infrastructure development and the fostering of industries in the Russian Far East as well.

**Figure 7: Basic Concept of the Japan-Russia Investment Platform**

Source: JBIC

Unlike funds that directly finance projects, the Japan-Russia Investment Platform is a mechanism whereby JBIC, RDIF and VEB individually invest in or provide loans to an individual project after JBIC and RDIF jointly propose and select projects and, when an agreement is reached, consider an optimal form of financing for each project.

The scale of operation is US\$1.0 billion, the combined total for Japan and Russia. Projects covered by the platform encompass a wide range of business operations, from business operations in the Far East and Siberia, including infrastructure development, new technologies in urban development, such as Smart City, and the introduction of state-of-the-art medical technologies and equipment to alternative energy projects, development of coal and mineral resources, and manufacturing and services industries.

The establishment of the Japan-Russia Investment Platform was conceived after VEB Chairman Vladimir Dmitriyev strongly urged JBIC in 2012 for the launch of a joint investment fund by JBIC and RDIF with a scale equivalent to the US\$2.0 billion Russia-China joint investment fund VEB established jointly with China Investment Corporation (CIC), a Chinese government-affiliated fund. Initially, JBIC had some concerns about the fledgling RDIF becoming an investor with responsibility, and the unimpressive performance of the Russia-China joint investment fund. Without sticking to the form of an investment fund, JBIC proposed that (1) both sides should agree on priority investment areas for enhanced effectiveness; (2) the new entity should be a framework of cooperation to discover feasible projects that can be expected to yield profits; and (3) it should be named the joint investment platform by avoiding the naming of a fund. Agreement was eventually reached after several rounds of negotiations. It is hoped that PPP candidate projects with high feasibility can be brought to a reality by JBIC, RDIF and VEB cooperating in the development of projects from the initial stage.

#### 4.2. Direction of Future Cooperation in the Far East Development

The Japan-Russia Investment Platform is a framework of collaborative support by JBIC, RDIF and VEB for projects in which Japanese companies participate in order to expand Japanese companies' business operations and technological presence in Russia, but JBIC also has the mechanism of cooperation for the Far East development in place other than the investment platform.

In September 2013, JBIC concluded a business cooperation agreement with the Far East and Baikal Region Development Fund (FEDF)<sup>5</sup>, a wholly-owned subsidiary of VEB, on the establishment of the "Far East and Baikal Infrastructure Development Partnership."

Under the partnership, JBIC and FEDF exchange information on infrastructure development projects in the Far East and Baikal region, cooperate for the development of such projects, hold consultations for the development of projects among parties concerned, and share knowledge about the sector of infrastructure utilizing private-sector resources.

As described in Section 2 of Chapter 2, the development of the Far East and Baikal region is positioned as the top priority of the Russian government with the adoption of the federal state program, "Far East and Baikal Region Socio-Economic Development," in April 2013, offering the prospect of accelerated infrastructure development there going forward. Japanese companies are also showing increased interest in participating in infrastructure business in the Far East and Baikal region. Through the "Japan-Russia Investment Platform" and the "Far East and Baikal Infrastructure Development Partnership" described above, JBIC intends to support the further deepening and development of Japan-Russia economic relations through infrastructure development in the Far East and Baikal region, by encouraging the development of feasible and bankable projects.

#### **Conclusion**

The development of the Russian Far East is a top priority for Russia and its development is in the interests of Japan (in terms of the secure supply of energy resources and participating in infrastructure development and fostering the growth of manufacturing and other industries) as well, and is also expected to contribute to the development of the Japan Sea Rim Economic Subregion.

On the other hand, the Far East development itself is of extremely low investment efficiency because of the vastness of the Far East and severe natural conditions. Though the Russian government recognizes the importance of Asia as the growth engine of the world economy, whether it can promote the Far East development continuously and effectively going forward requires a close watch.

The Russian government's Far East Development Program has shown the way to infrastructure development in the Far East. Given the regional characteristics of the Far East with a small population and insufficient infrastructure and industrial foundation, however, it is important for the Russian government to take a flexible approach of selecting priority projects of vital importance and high utility value, and utilizing investment under government budgets to develop transportation infrastructure, such as unprofitable railways, ports, and roads, while proactively inviting domestic and foreign companies and investors to join when bankable infrastructure projects suitable for private-sector investment emerge. From this

perspective, JBIC intends to contribute to the “Win-Win” Far East development for both Japan and Russia by supporting, on top of infrastructure development in the Far East, the discovery of projects to introduce Japan’s cutting-edge technology to the Far East, including investment in the manufacturing industry, renewable energy development and medical services, and the development of bankable projects, through the Japan-Russia Investment Platform with RDIF and business cooperation with FEDF.

Some physical distribution routes, including the modernization of railways, are being developed among the Russian Far East, the northeastern part of China and the Korean Peninsula. Going forward, if the grand scheme of the mutual extension of the Trans-Siberian Railway and the Trans-Korean Railway is realized, it would be a major step forward for the realization of a plan for a Trans-Eurasian railway covering some 11,000 kilometers between Busan, South Korea, and Berlin, Germany, via Moscow. Moreover, like a trans-Korean railway, construction of a natural gas pipeline that runs through the Korean Peninsula is reportedly under consideration. These projects that help enhance the regional connectivity will also have an impact on Japan that forms the same economic bloc across the Sea of Japan. For example, if a pipeline is constructed to carry natural gas from the Russian Far East to South Korea, the pipeline may be extended from South Korea to Japan to supply Russian natural gas to Japan. Also, if the railway from Busan Port, to which regular Japanese container vessels are operated, is extended into the continental interior, it would mean the birth of a new physical distribution route.

Under the Putin and Abe governments, Japan and Russia are currently enjoying the closest bilateral relations at both the governmental and industrial levels, and a good cooperative relationship is in place between the two countries for the future, including the Far East development. Amid the further deepening of Russia-China and Russia-South Korea relations over the Russian Far East, we are now presented with a superb opportunity to proactively develop the grand design of the Japan Sea Rim Economic Subregion. When we view Northeast Asia facing the Sea of Japan as a single economic bloc and take a second look at transportation infrastructure, including airports, seaports, and railways from the perspective of “international logistics,” we can find a huge growth potential there. We need a bold and flexible way of thinking to take a view of Northeast Asia, including the Russian Far East, as a “plane.”

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<sup>1</sup> The Russian Far East means the nine component entities of Primorsky Region, Khabarovsk Region, Sakha Republic, Amur Oblast, Sakhalin Oblast, Kamchatka Region, Jewish Autonomous Oblast, Magadan Oblast, and Chukotka Autonomous Okrug.

<sup>2</sup> At a meeting of a government committee on socio-economic development matters in the Far East, held in Khabarovsk in October 2013, the decision was taken to transfer the following powers to the Ministry for Development of Russian Far East:

1. The Ministry of Regional Development’s rights concerning coordination of the selection and implementation of priority investment projects;
2. Allocation of subsidies by the Ministry of Regional Development and the Ministry of Finance to regional social and infrastructure development;
3. The Ministry of Regional Development’s evaluation of the operational efficiency of regional administrative organizations;
4. The Ministry of Regional Development’s coordination of city construction plans and regional development schemes; and
5. The Ministry of Regional Development’s participation in the management of special economic zones.

<sup>3</sup> VEB is a policy-implementing institution, wholly owned by the Russian government, with the purpose of

the development and advancement of the Russian economy. The Supervisory Board of VEB comprises the Prime Minister of the Russian government, the Deputy Prime Minister, and relevant ministers. Its chairman is Prime Minister Medvedev.

<sup>4</sup> RDIF is a government-affiliated fund established in 2011 for the purpose of fostering Russia's domestic industries and revitalizing investment at the initiatives of then President Medvedev and then Prime Minister Putin. RDIF is wholly owned by the Russian government via VEB and has the asset size of US\$10.0 billion.

<sup>5</sup> FEDF is a fund established in 2011 as a wholly-owned subsidiary of VEB with the purpose of infrastructure improvements in the Russian Far East and the Baikal Region.

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