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# Russia's reorientation to the East: How much does economy matter?

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The economic development of Russia's Far East has been announced as a policy priority, to be facilitated by an ambitious 'pivot' to Asia. In 2015, speaking at the first Eastern Economic Forum in Vladivostok, President Vladimir Putin stressed the Russian Far East as a key region for the development of the Russian Federation, and a region to be effectively integrated into the Asia-Pacific region as a whole (Kremlin.ru 2015). At the second Forum, in September 2016, ideas about developing an 'Energy Super Ring' (to involve China, Japan, Mongolia, Russia and South Korea) and turning Vladivostok into Russia's 'San Francisco' were mooted. Russian officials have also repeatedly declared that the government wishes to strengthen economic ties with China, Japan and South Korea. But – just how credible is Russia's commitment to reorient itself economically towards Asia?

This policy brief assesses Russian involvement in the growing Asia-Pacific economies, and offers an overview of the Far Eastern dimension of Russia's economic relations with its major Asian partners, 2010–2016. It discusses the dynamics of investment and trade relations, and reflects on Russia's changing economic priorities before and after the conflict with Ukraine and introduction of international sanctions, with a focus on implications for Russia–Asia relations in the Russian Far East.

**Context matters**

For decades, the Russian Far East has been recognized as a region of unfulfilled promise and potential (Bradshaw 2012). Natural population growth has remained negative and outmigration high, and demographic decline continues to slow economic development. Other factors with negative impacts on the economic development of the region are geography (huge uninhabited territories), lack of infrastructure, harsh weather conditions, insufficient labour resources and the limited capacity of the main east–west transport artery: the Russian railway system.

Five main factors can be said to shape the context of the Russian Far East's integration into Asian markets:

- the international sanctions regime
- Russia's prioritization of economic openness vs import substitution
- economic infrastructure
- continued reliance on energy as the major driver of economic development
- the business climate.

To start with the first of these factors: international sanctions have had a significant impact on the development of the Russian Far East – not least because the USA and other Western countries were major investors in the region prior to 2014.

Second, Russia's countersanction measures and the introduction of import substitution policies have negatively affected the region. Moscow's post-Crimea import substitution plan foresees the implementation of more than 2,000 projects across 19 sectors of the economy between 2016 and 2020 (Edovina and Shapovalov 2015). State incentives for import substitution – like infrastructure grants and preferential domestic treatment in government procurement contracts – are held to have a perverting effect on the economy. In any case, Moscow's attempts to open the Russian Far East to foreign investment have been undermined by the simultaneous introduction of import substitution policies, which in practice means pursuing greater economic isolation.

Russian economist Sergei Guriev (2015) has argued that import substitution is part of Russia's ongoing 'de-globalization'. However, while import substitution complicates access for foreign investors, it does not rule out FDI. What it does mean is that foreign firms planning to invest in the affected sectors are now required to 'localize' their production instead of simply exporting their products to Russia. The inherent tension between openness and import substitution complicates economic governance in the Russian Far East.

As to the third factor, the challenges related to integrating the Russian economy in the Asia-Pacific markets are almost insurmountable. If the sanctions were to be lifted, it would be much easier for Russia to reintegrate economically with Western markets, than to achieve substantial progress in the Asia–Pacific. The combination of underdeveloped infrastructure, demographic challenges and lack of skilled labour in the Russian Far East as compared to the western part of Russia all speak in favour of reintegrating with the West rather than pivoting to the East. Moreover, after the Ukraine crisis, the Russian government has prioritized infrastructure development in Crimea, which has put substantial pressure on the federal budget. The budget for the development of the Russian Far East has thus had to take cuts – which further undermines the chances for the eastward pivot.

Fourth, energy remains the main attraction for foreign investors in the Russian Far East. Non-energy industries are thus underprioritized, leading to weak diversification in terms of FDI. The fifth factor, the development of the business climate, is discussed below.

Overall, the Russian Far East serves as a clear example of how the Federation's external economic constraints and limited domestic policy options hinder regional economic development. While Moscow stresses the goal of becoming economically self-sufficient through import-substitution policies, it must acknowledge that foreign investors will have to play an important role in the process of developing the Far East.

**Attempts to improve business climate: new efforts, old story?**

Improving the business climate has an important role in facilitating Russia's turn to Asia. In assessing the progress in business climate development after 2014, we should note that much has been done to develop hard infrastructure for attracting FDI. Most importantly, the central government has introduced a special investment regime, the 'advanced special economic zones' (ASEZs). Priority sectors are construction materials, timber processing, fish processing, tourism, metallurgy, the agro-industrial complex, automobile parts, logistics, petrochemistry and infrastructure. The goal is to introduce one or two ASEZs in each of the nine federal subjects in the Russian Far East, to ensure balanced distribution of economic activities.

The process of developing ASEZs is closely linked to the parallel introduction of the Free Port of Vladivostok. The latter project, adopted in 2015, brings together 15 municipalities in the southern part of Primorskii Krai that will enjoy special tax and customs privileges. To oversee the work of the ASEZs and the Free Port, Moscow has created a series of new administrative bodies:

- the Department for Advanced Special Economic Zones and Free Port of Vladivostok under the Ministry for the Development of the Russian Far East (the Ministry itself was established in 2012)
- the Far East Human Capital Development Agency (aimed at attracting skilled labour and facilitating relocation to the Far East)
- the Far East Investment and Export Agency (responsible for drafting investor proposals and identifying new ASEZ residents)
- regional investment development agencies in every region of the Far East.

Despite these attempts to make the Russian Far East, and Vladivostok in particular, an attractive place for investment, thus far there seems to have been little improvement in the business climate. In a 2014 survey of the investment climate in 21 Russian regions, Khabarovsk and Sakha received the second-lowest rating and Primorskii Krai the lowest (Lee and Lukin 2015: 50). The situation has not changed much since then: in fact, due to the overall economic stagnation, general perceptions of the business climate have worsened.

**Trade: who is at the helm?**

China, Japan and South Korea have been the main trade partners of the Russian Far East, with 80 per cent of the region's total trade in 2014. However, since then, exports and imports between the Russian Far East and China, Japan and South Korea have stagnated in volume and declined significantly in value. The main Western exporter is the USA, followed by Norway, Brazil and Germany; while Belgium is by far the biggest Western importer from the region. Interestingly, in terms of value, Far Eastern imports from the West have remained stable – it is the main Asian trade partners that have suffered the most in the Far East (see Figure 1.)

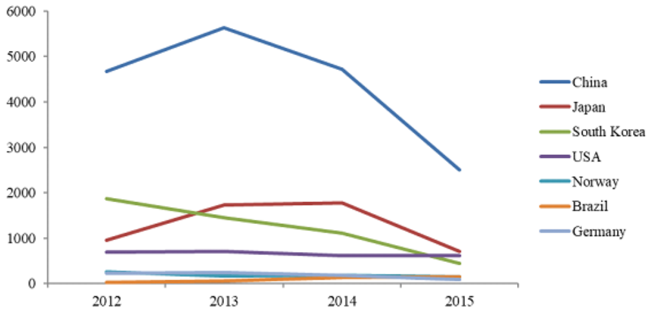


*Figure 1. Imports to the Russian Far East from main trade partners (million USD)*

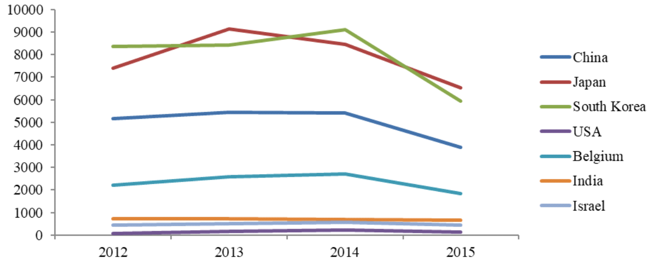


*Figure 2. Exports from the Russian Far East to main trade partners (million USD)*

On the national level, China remains the Russian Federation's biggest trade partner. In 2015, its share in Russia's total foreign trade amounted to 11 per cent (Dave 2016). However, China's current relatively passive position on trade, on FDI and on cross-border economic collaboration has raised some concerns: In practice, China was more active in developing economic ties before the Western sanctions were introduced. In 2015 total Chinese exports to Russia decreased by 34.4 per cent, as compared to a 6.8 per cent increase in 2014. The ambitious goal adopted in 2011, of achieving an annual total trade turnover of USD 100 billion by 2015, proved unrealistic – turnover in the latter year amounted to only USD 64.2 billion. Achieving the foreseen double increase by 2020 now seems even less likely, given the current stagnation in trade relations between the two countries, the struggling Russian economy and slower economic growth in China.

**FDI in the Russian Far East**

FDI does not exceed 10 per cent of total investments in the Russian Far East: around 90 per cent of investments continue to stem from domestic investors. The volume of FDI has been less affected by the international sanctions and the economic slump than the case with trade: while total trade since 2014 has declined dramatically, total FDI in the region appears to have taken less of a hit. From Figure 3 we see that total FDI after 2014 from the main Western investors decreased somewhat, whereas FDI from Japan and South Korea showed modest growth. Only China broke this pattern, with a clear upward trend across the period in question. However, Chinese FDI 2014–2015 was significantly lower than the Dutch FDI in 2010–2011 in connection with Shell's investment in the Sakhalin oil and gas fields.

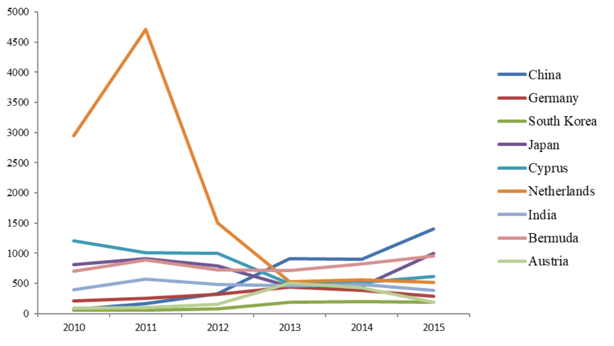


*Figure 3. FDI in the Russian Far East by main partners (million USD)*

Bermuda and Cyprus rank among the main investors in the Russian Far East in 2014–2015, but this investment is predominantly of Russian origin: many Russian state corporations and private firms use offshore accounts, registering in various tax havens in order to reduce the tax burden.

As seen in Figure 3, China has in recent years been the single biggest investor in the Russian Far East. However, many of the investment projects promised by China after 2014 have never materialized, at least partly related to the international sanctions regime and ensuing Chinese apprehensions. Still, Russia and China have a shared interest in developing the sparsely populated but resource-rich territories of the Russian Far East. The energy sector has been the main driver. In 2014, the conclusion of a USD 400 billion contract to build the Power of Siberia pipeline from Irkutsk and Sakha to China was intended to send a message to the West: Russia had alternatives to the European gas market. The following year, Rosneft signed contracts with China worth over USD 30 billion, likewise planned to supply oil to the Chinese market. Since then, however, economic recession and infrastructure gaps in the two countries have complicated implementation of these huge energy projects, and implementation negotiations are currently stalled.

In other sectors there are some noticeable success stories. For example, over USD 109 million has been invested in a timber plant in Khabarovsk. The Russian–Chinese Fund for Agro-Industrial Development has set a goal of disbursing USD 1.2 billion to the agricultural sector over the three-year period 2016–2018. Further, Chinese firms have invested in a cement plant in Amur Oblast and have expanded their activities in the Sakha Republic and Primorskii Krai. Finally, although slow progress on the Russian section has raised concerns, the Amur Bridge, connecting Blagoveshchensk in Russia with Heihe in China's Heilongjiang province, is expected to be completed by 2019.

In general, however, it has proven difficult to attract FDI or domestic investment in sectors beyond natural resource extraction. Seeking to balance Chinese interests, Russia has continued cultivating other partners to add more competition for investment in the region's resources. South Korea and especially Japan are viewed as the most promising potential partners here. For South Korea, integration with the Russian Far East is deemed attractive as it would strengthen connectivity between Eurasia and the Korean peninsula. For the Korean ambitions to be fulfilled, however, hard infrastructure must be in place in the Russian Far East.



As for Japan, the Ministry for the Development of the Russian Far East has stated that the volume of Japanese FDI may easily exceed that of China in the near future (Gazeta.ru 2016). If Moscow and Tokyo manage to reach agreement on the Kuril Islands/ Northern Territories, that would undoubtedly boost economic cooperation between the two countries. Although Japan alone will not be able to satisfy Russia's enormous needs in terms of regional FDI, Russia could use Japan as a wildcard in its negotiations with China: increased competition between Beijing and Tokyo over resources and influence might lead to increased FDI in the Russian Far East. This is no easy task, though: Russia will need to improve its business climate significantly before it can become be an attractive destination for Japanese investors.

**Conclusions**

Moscow still lacks a unified strategy regarding the economic development of the Russian Far East: different agencies promote divergent agendas and the government pursues contradictory policies of import substitution while trying to open up the Russian Far East to foreign investment.

Implementing the ambitious plans for developing the Russian Far East will require substantial foreign investment – but, paradoxically, pivoting to Asia can hardly be achieved without investment from Western countries (Jeh et al. 2015: 6). And as long as the sanctions regime remains in place, large-scale Western investment will not be forthcoming. Moreover, instead of unequivocally facilitating an eastward pivot, the Ukraine conflict has complicated the reorientation to the East – domestically in Russia, as well as internationally.

In the broader regional context, the Russian Far East remains a minor actor. Its trade is still oriented largely toward European Russian markets; and in economic matters, the Russian double-headed eagle continues to look more to Moscow than to the Pacific.

To a large extent, developments in the Russian Far East reflect the overall economic situation in the Russian Federation, which has worsened since 2014. This downturn has been caused partly by external factors (most importantly, the collapse of the oil and gas prices and the international sanctions), and partly by internal factors (including the adoption of import-substitution policies).

Russia's efforts to improve the hard infrastructure to facilitate foreign investment in the region have brought some results. The region has become more diversified, with new infrastructure introduced to attract investment beyond the industries connected with natural resource extraction. The increase in Russian offshore capital being reinvested in the Russian Far East is a good sign; several new initiatives, such as the creation of the Free Port of Vladivostok and state support for new private projects through the Far East Development Fund, have also contributed to this diversification effect. However, the external benefits are yet to be seen in practice.



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