

The Current Status of Issues Concerning and Prospects for Investment Cooperation Between Japan and Eastern Russia

Anatoly G. Bury

Deputy Director of the Secretariat, Interregional Association "Far East & Zabaikalye"

Around 40 years have passed since investment cooperation between Russia and Japan began.

In the 1960s and 1970s, large-scale projects involving the development of natural resources in Eastern Russia occupied an important position in economic relations between Russia and Japan. In implementing these projects, the Russian side first of all bought the machinery and equipment needed for industry in Siberia and the Far Eastern region from Japan and then supplied Russian produce to Japan as part payment for these. The nine General Compensation Agreements dealt mainly with the timber sector and the fuels and energy sector.

For example, the General Compensation Agreement on the South Yakutiya coal deposit played a part in increasing exports to Japan of Russian-produced coke and coal for use in power generation. At the same time, Japan's refusal in the 1980s to buy coal for the purchase of which it had already concluded a contract was one reason for Russia's debts to Japan.

The freezing of Japanese investors' foreign currency accounts (worth a total value of about \$1 billion) by Vneshtorgbank in 1993 was the biggest negative factor affecting economic relations between Russia and Japan.

As a result of changes in Russia's economic situation and a reduction in Japanese demand for coke, the countries were obliged to explore new forms and methods of cooperation, such as establishing joint ventures that would attract investment and technology from Japan. In the 1990s, the number of companies established in the Russian Far East with Japanese capital grew rapidly. During this period, tax incentives—particularly the three-year exemption from taxes on profits—provided a welcome fillip to investors. Examples of successful Russo-Japanese joint ventures include Igirma Tairiku and STS Tekhnowood in the timber sector and Vostoktelecom in the communications sector.

A number of Russo-Japanese joint ventures established during Russia's transition from a controlled economy to a market economy failed, and these cases have proved to be an obstacle to Japanese investment in the economy of the Russian Far East. At the time, there were no mechanisms to protect investments and the foreign exchange, customs duty and tax administration systems had only just been built. Although those who established joint ventures made considerable profits, they were too late in responding to changes in Russia's economic climate and legal infrastructure and did not revise their articles of association. As a result, disputes arose between the Russian and Japanese founders of these companies, as was seen in the cases of Sakhalin's Santa Resort and Sakhalin Sapporo.

It is common knowledge that, at that time, Russian companies were thinking more about making a profit as quickly as possible, rather than developing production activities. Before long, most Russo-Japanese joint ventures

ceased their activities, with the remainder involved solely in transport "intermediary" activities.

As a whole, the bilateral investment cooperation that took place in the 1990s can be assessed as being unstable and not commensurate with the potential on both sides. Japan's share of cumulative foreign investment in Russia was less than 1.2%.

In order to support reform, the Japanese government formulated a succession of economic support programs for Russia in the 1990s (worth around \$6 billion). Some of the contributions were earmarked for the purchase of Japanese machinery and plant as part of the implementation of specific projects. For example, \$200 million was to be used for the project involving the reconstruction of wireless communications systems linking Moscow and Khabarovsk conducted by Rostelecom and Sumitomo Corporation. In addition, \$400 million was shared out among a number of projects, including the installation of a microwave production line in the Impul's factory in St Petersburg and the replacement of facilities at the KamAz engine plant. Furthermore, \$500 million of credit for humanitarian support was granted, with some of this being diverted to investment projects. However, at the end of the 1990s, as a result of such factors as a tougher stance on the part of the Japan Bank for International Cooperation (JBIC), which demanded guarantees from the state for finance for joint projects, the two countries were unable to reach agreement regarding valid uses for Japan's aid to Russia and the greater part of the money allocated as aid was not used.

After the formulation in November 1997 of the Yeltsin-Hashimoto Plan, which anticipated an expansion in bilateral cooperation, the prospects for cooperation in the field of investment became brighter. However, the overall attitude of the Japanese business world towards large-scale investment projects in Russia was still rather cool. Given this situation, the two governments speeded up work aimed at establishing a system of guarantees for investment activities. The main institutional and legal framework for bilateral investment cooperation was the Russo-Japanese Investment Protection Agreement, which was signed by Prime Minister Obuchi when he visited Russia in November 1998.

In 1999, 220 Japanese-affiliated companies were registered with the Russian government. Of these, 44 were 100% Japanese-financed companies, with another 173 being Russo-Japanese joint venture joint stock companies. In addition, 84 representative offices were registered. More than 60% of the companies doing business at this time were involved in trade intermediary services and consulting services. The remainder were active in the fields of oil drilling and oil processing, light industry, the processing of agricultural produce, timber and secondary materials, construction, and the processing of foodstuffs.

The attraction of Japanese investors with the aim of implementing the Special Federal Program for the Economic and Social Development of the Far East and Zabaikal Region 1996–2005 was an important step in the process of revitalizing Russo-Japanese investment cooperation. Six top priority projects were identified: the completion of the Bureya hydroelectric power station (Amurskaya oblast); the development of the Aniva gas deposit (Sakhalinskaya oblast); the establishment of the Elektrum composite metal-working complex (Primorsky krai); the construction of the third branch line of the Berge–Yakutsk gas pipeline; and the construction of gas pipelines on the Sea of Okhotsk coast–Petropavlovsk-Kamchatsky and the Sakhalin–Komsomol'sk-na-Amure–Khabarovsk–Vladivostok routes.

Under the auspices of the Trade Representation of the Russian Federation and the Keidanren's Japan-Russia Business Cooperation Committee, a project briefing was held in Tokyo in January 1999. In addition, at a Russo-Japanese workshop held in Sapporo in February 1999, the decision was taken that the Japanese side should participate to the greatest extent possible in bringing these projects to fruition. In March 1999, the 4th Meeting of the Japan-Russia Inter-Governmental Committee Far East Subcommittee was held in Tokyo, at which it was agreed that the Russian side would conduct a preliminary feasibility study. It was determined that, once the feasibility study had been compiled, the Keidanren's Japan-Russia Business Cooperation Committee would request that the Japanese government provide the necessary finance for feasibility studies of each project as a grant, in anticipation of the participation of Japanese companies in these projects in the future.

In 2000, the Japanese government contributed around \$400,000 to a feasibility study of the Bureya hydroelectric power station project. The study was completed within the prescribed period, after which Japanese companies proposed that the Japanese government use money provided to Japanese trading companies for the purpose of promoting exports of Japanese goods and services in order to finance construction of the Bureya hydroelectric power station. JBIC then specified the conditions that the financing period would be 15 years, with the money to be provided in yen and the loan to be subject to an interest rate of 7–8%. In addition, provision of the loan was made subject to the impossible condition that Japanese plant worth 50% of the value of the financial contribution was to be purchased. This was unlikely to be acceptable because the Bureya hydroelectric power station had been designed to use Russian-manufactured plant. The conditions attached to the loan were not accepted by United Energy Systems of Russia (UES). However, at the same time, UES believes that there are future possibilities for Russo-Japanese cooperation in the Bureya hydroelectric power station project. In particular, it thinks that cooperation in the implementation of the project will become possible through direct financing within the implementation framework of the Kyoto Protocol.

The Japanese government contributed money to preparatory work on a plan for developing Zarubino Port. This work was implemented within the prescribed period,

but because Zarubino Port became a joint stock company, it ceased to be an integrated business project and the private company could not find the money required for its reconstruction.

Based on its experience of thoroughly researching the potential for participation in the foregoing projects, the Japanese side altered its position on the projects succeeding these ones at workshops held in 2000 and 2001. After the money contributed by the Japanese government was allocated to work on finalizing the content of existing feasibility studies based on JBIC's requirements, rather than to financing new studies, this change in the Japanese position manifested itself in Japanese demands for guarantees for each project from the Russian federal government.

In 2002, the Japanese side completed feasibility studies for three gas pipeline projects (the Sakha Republic, Khabarovsk krai and Kamchatskaya oblast). However, the cooperation did not come to fruition because the Russian federal government refused to provide guarantees for these projects, which are now being conducted independently by the Russian side.

In the 1990s, investors were confronted by Russia's unstable macroeconomic situation, triggering a sense of uncertainty that they would be unable to make profits in the future even if they undertook capital investment. The taxation system, which was characterized by restraint, encouraged tax evasion and capital flight, and had negative elements that blighted efforts to attract investment. Moreover, the poor state of the investment environment was exacerbated by corruption and an incomplete system for the protection of property rights.

Japan has a proverb that is the equivalent of the English saying "look before you leap", which literally translates as "tap the bridge as you cross it". This proverb reflects the tendency of Japanese entrepreneurs to "keep on tapping" for a long time while the bridge has not yet collapsed and then, when it collapses because of all the tapping, to say, "it's a good thing we didn't try to cross it". In other words, we can say that Japanese entrepreneurs, in trying to avoid risk, tend to procrastinate about making decisions.

Japanese investment in Russia (excluding the Sakhalin oil and gas projects) around the turn of the century was negligible. According to Russian statistics, the cumulative value of direct investment by Japan stood at \$357 million as of 1st January 2000. The withdrawal of Japanese capital from Russia continued further in 2000. The cumulative value of Japanese investment in Russia fell by \$82 million during this period. All this signifies that Japan's share of Russia's overall investment cooperation with other countries has decreased. In other words, the Japanese business world has maintained its insistence that reciprocal relationships involve loans and has adopted an extremely cautious stance with regard to direct investment in the Russian economy.

The characteristics of Russo-Japanese relations in the early 21st century are the revitalization of political dialogue and the deepening of mutual understanding. The prerequisites for achieving a qualitative increase in Russo-Japanese investment cooperation in Eastern Russia that will

Graph 1. Trends in Japanese Investment in the Russian Far East and Zabaikal Region (1995–2003)

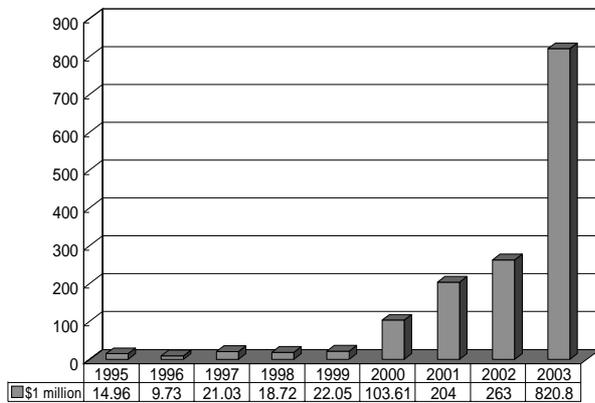


Table 1. Trends in Japanese Investment in the Russian Far East and Zabaikal Region (2001–2003, \$1 million)

	2001	2002	2003
Sakhalinskaya oblast	157.5	233.4	783.8
Primorsky krai*	29.7	19.8	25.9
Khabarovskiy krai	5.8	2.2	1.8
Kamchatskaya oblast	11.1	7.2	6.8

* 2003 Primorsky krai data are for the period January - September

take it to a new level have been put in place. At the same time, this era is characterized by the fact that areas of inconsistency have been reduced, thereby easing the tension that previously existed and increasing common benefits for both countries.

Japanese investment in the Russian economy exceeded \$1 billion in 2003 (increasing from \$441 million in 2002). Of this, \$960 million was investment in industry (putting Japan in 5th place by country of origin). If we include the Sakhalin projects, cumulative Japanese investment in the Russian economy totaled \$1.9 billion as of 1st January 2004. As a result of this achievement, Japan is ranked 10th among the nations investing in Russia. At the same time, the value of direct Japanese investment is \$1.353 billion, putting it in 6th place.

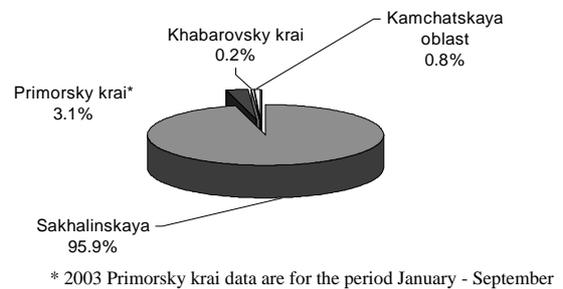
In 2003, Japan invested \$820.8 million in the economy of the Russian Far East and Zabaikal region. This was triple the amount invested in 2002 (\$263 million) (see Graph 1).

The fuels and energy industry is a strategic area for Russo-Japanese economic cooperation in the Russian Far East. The greatest potential lies in the implementation of the Sakhalin oil and gas projects (Sakhalin I and II), in which some Japanese companies are participating.

Japanese investment in Sakhalinskaya oblast in 2003 was worth \$783.8 million. This is 3.5 times the level of investment in 2002 (\$233.4 million) (see Table 1).

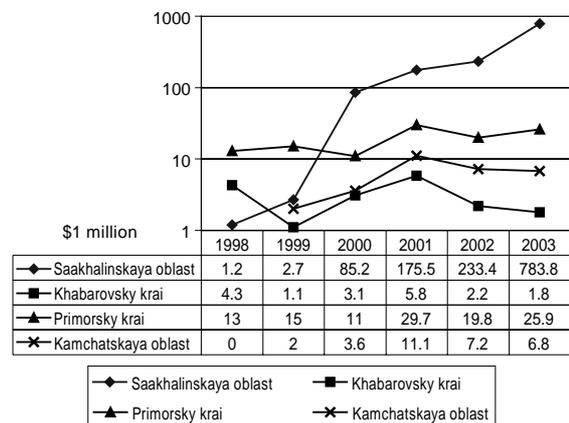
In 2003, 125 Russo-Japanese joint ventures were registered in Sakhalinskaya oblast, with capital provided through Japanese investment valued at \$36.1 million, based on figures listed in the companies' articles of association. The majority of Russo-Japanese joint ventures are traders or trade intermediaries, involved in the export of raw

Graph 2. Share of Japanese Investment in the Far East and Zabaikal Region by Administrative Regions (2003)



* 2003 Primorsky krai data are for the period January - September

Graph 3. Share of Japanese Investment in the Far East and Zabaikal Region (1998–2003)



* 2003 Primorsky krai data are for the period January - September

materials.

Except for Sakhalinskaya oblast, Primorsky krai occupies an important position with regard to attracting Japanese investment. In 2003, Japanese investment in Primorsky krai accounted for 3.1% of all Japanese investment in the economy of the Russian Far East and Zabaikal region (see Graphs 2 & 3). In terms of the actual amount of money, this works out as \$25.9 million (January - September 2003). The most intensive investment was in Dal'moreprodukt (DMP: a marine produce company with publicly held stock), STS Tekhnowood (a timber processing company with privately held stock, located in Plastun), Vostoktelecom (power system services and wireless communications), NBAMR (a marine produce company with publicly held stock, located in Nakhodka), Versailles (hotel business), and Vladivostok Airlines (an air transport company with publicly held stock).

In 2003, 58 Japanese-affiliated companies were registered in Khabarovskiy krai, up 65% on the previous year. Of these, 21 were joint ventures, 35 were 100% Japanese-invested and 2 were representative offices. The value of Japanese investment in the territory in 2003 was \$1.8 million (6.6% of all investment in Khabarovskiy krai).

As can be seen from these data, a great deal of untapped potential still remains in the field of Russo-Japanese investment cooperation in Eastern Russia.

It goes without saying that the fuels and energy

industry is one of the top priority sectors for bilateral cooperation. For Russia, Japan's participation in energy projects means not only an influx of foreign currency, but also the entry of its energy resources into Northeast Asian markets.

As has already been noted, the most promising projects are the jointly implemented Sakhalin oil and gas development projects (Sakhalin I and II). It is planned that Sakhalin II will begin production in 2006 and 2007, according to the project's planned productivity.¹ Mass production of hydrocarbons from the Sakhalin I project is also due to begin around the same time.²

Discussions are continuing regarding Japanese participation in the project aimed at laying an oil pipeline from Siberia to Nakhodka. If the Pacific oil pipeline is brought to fruition, the relationship between Japan and Russia will become profoundly interdependent and, mutual trust between the two is likely to be reinforced as a result. This project has strategic significance for Russia, as it will boost the production and processing of crude oil in its Far Eastern region.

What are important in the Russian Far East are related projects that will form a gas distribution system, with the aim of solving the region's energy supply problems. These are the construction of the third branch line of the natural gas pipeline from the Srednevilyusk gas condensate deposit–Mastakh–Berge–Yakutia (Sakha Republic), the construction of a gas pipeline from Sakhalin–Komsomol'sk-na-Amure–Khabarovsk–Vladivostok, the development of the Kshuk gas condensate deposit and the construction of a gas pipeline from the Kshuk gas condensate deposit to Petropavlovsk-Kamchatsky. Other projects of the utmost priority include the construction of an open-cast mine at the El'ga coal deposit in the Sakha Republic and a production and processing complex at the Talakan oil and gas condensate deposit.

In addition to feasibility studies, projects developing the Trans-Siberian Railway (TSR) are also a priority. Development of the TSR would afford Russia further opportunities to expand into various markets in Northeast Asia, while providing Japan with a short route to European commodity markets.

Prime Minister Koizumi's January 2003 trip to Russia, which included a visit to Khabarovsk, confirmed that both Russia and Japan have an interest in the development of cooperative relations. During the visit, a Russia-Japan action plan that aims to revitalize links at all levels was drawn up. Under this action plan, the following measures are planned:

1. The establishment in 2004 of a Russia-Japan Trade and Investment Promotion Organization. The main roles of this organization will be to provide information about Russian and Japanese businesses, potential trade and investment partners and the legal system, to facilitate the resolution of disputes between Russian and Japanese companies, and to implement measures aimed at preventing problems and dealing with problems if they do arise.
2. The enhancement of forms of finance for joint projects, including loans provided in return for the provision of guarantees by companies and banks participating in the projects.
3. Cooperation in the development of energy resources in Eastern Russia.

In order to examine the potential for expanding investment cooperation, it would be advisable to continue to select joint Russo-Japanese projects within the framework of workshops on Russo-Japanese economic cooperation.

In order to improve the investment environment, the Russian government has adopted a strategy of standardizing its immigration control, border control and customs systems, as well as its industrial standards and its financial accounting standards; in addition, it is continuing to work on formulating systems that will benefit investors, such as guarantees that will function effectively, and foreign capital protection and insurance.

If these measures are brought to fruition, a broad range of opportunities for expanding investment cooperation between Eastern Russia and Japan will undoubtedly be opened up.

(Translated by ERINA from Russian to Japanese and English)

¹ (Editor's note) It has been reported that year-round production of crude oil will begin in 2006, with LNG exports beginning in 2007.

² (Editor's note) Sakhalin I will mainly focus on oil production.