

Integration or Disintegration?

Challenges for the Russian Far East in the Asia-Pacific Region

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Integration or Disintegration: Challenges for the Russian Far East in the Asia-Pacific Region

The disintegration of economic links within the Russian Federation has propelled the regions comprising the Russian Far East to find new markets in Asia, but, ironically, the very weakness of the Russian state also has proved to be the greatest obstacle to the economic integration of these regions with the Pacific Rim economy. Russia's flawed mechanisms for coordinating center-regional relations and poorly developed regional institutions, have limited the ability of the Russian Far East to promote economic relations with Asian neighbors.

In the past three years President Vladimir Putin has taken steps to restructure center-regional relations in hope of creating a more effective state. We examine the consequences of these reforms both for Russia's future political development and for the economic integration of the Russian Far East in Northeast Asia. This article examines the twin challenges confronting the Russian Far East: 1) economic integration in the Asia-Pacific economy, a region that has been emblematic of robust trade but weakly institutionalized economic linkages, and 2) political disintegration within Russia, resulting from ineffective patterns of center-regional relations, crime, and corruption. Particular attention is directed to trade with China, Japan, the United States, and South Korea, investment in transportation and energy projects, and labor cooperation with China and North Korea.

Regionalism, Economic Integration, and the State

Initial faith in the ability of the Russian Far East to become a part of Asia's dynamic economy coincided with the boom in intra-Asian trade and investment in the first half of the 1990s. At a time when Europe was moving toward the creation of supra-national organizations within the framework of the European Union, Asia was proclaiming the priority of market forces over institutions. Asia's loosely functioning regional economic organization, the Asia Pacific Economic Council (APEC), was founded in 1989 on the principle of "open regionalism," which recognized the power of market forces in promoting trade and confined the role of governments to the creation of a climate hospitable to the expansion of economic linkages.¹ Unlike Europe and North America, there is no region-wide free trade agreement in East Asia and trade liberalization remains dependent on unilateral efforts by individual countries. Export-led growth has given the East Asian countries an important incentive to pursue unilateral trade liberalization, however, as these states have benefited greatly from free trade.²

Private capital flows also have played a driving role in economic cooperation in Asia. By taking advantage of the low transportation costs and other savings involved in regional cooperation, firms and investors have been able to compensate for the continuation of barriers to free trade in some areas.³ Unlike studies of European integration, which largely focus on activities by national governments to regulate regional cooperation via international institutions, research on trade in Asia has centered on the economic links created by a region's search for markets and the opportunities for regional cooperation engendered by geographic proximity, the presence of economic complementarities, and the level of infrastructure development.⁴ Where central

governments have played an important role, however, is in establishing the policy framework geared to the development of regional trade zones.

Economic interdependence emerged in Asia due to a combination of government and private sector initiatives to promote economic linkages across political lines. Some observers saw “natural economic territories” resulting from such efforts, linking together areas such as Guangdong province, Hong Kong, and Taiwan, as well as Shandong province with South Korea, and Singapore with Johor in Malaysia and the Riau islands in Indonesia.⁵ Kenichi Ohmae, for example, viewed the natural economic territories (what he calls “region-states”) as the beginning of a new borderless international order, in which people, information, investment, and industries flow unimpeded across national boundaries.⁶ For Ohmae the central government had a limited role to play in this new world—as a provider of military security, infrastructure, and a sound currency. He noted that central governments, fearing a weakening of their sovereignty, might try to reign in the economic activities in the localities, a step which inevitably will have negative consequences for economic development.⁷

While some analysts denigrated the role of politics in the world economy, others, such as Robert Gilpin, argued that state interests often underlie what appear to be purely economic phenomena, such as the expansion of multinational corporations.⁸ Gilpin claimed, however, that market forces and states often pull in different directions: states require political control over territorial boundaries, but markets thrive when politicians refrain from over-regulating them. Moreover, Gilpin found that just when an expanding international economy begins to permit greater interdependence, individual states tend to intervene in their own economies to control economic growth.⁹

The fall of communist regimes in Eastern Europe, ruled by parties adhering to Marxism—the ideology, which foretold a time when nation-states would wither away—paradoxically led to the weakening of these nation-states. They proved administratively weak without the coercive and unifying role played by the communist party, and some countries, such as the Russian Federation, face significant centrifugal pressures in addition. While much of the studies of regionalism concern prospering market-oriented economies, the case of the Russian Far East calls attention to the conflicting demands imposed by simultaneous processes of economic transition and increasing openness to regional economic linkages. Despite the existence of an economic basis for cooperation, the integration of the Russian Far East into the Asian economy has been a problematic process due to inadequate political and economic institutions on the central and regional levels and center-regional differences over economic development.¹⁰

In the wake of the 1997 Asian financial crisis, greater attention is being paid to the institutional underpinnings of economic success. While the initial wave of economic success in Asia was attributed to “Asian values”—the premium placed on hard work, education, and cohesive communities—the crisis now is being blamed on inattention to economic fundamentals and especially to flawed political and economic institutions. In particular, the lack of transparency of banking institutions, inadequate controls over financial markets, cronyism, and political criteria used for economic decisions have been faulted for their role in the dramatic collapse of some of the world’s most dynamic economies. All of these flaws are present in Russia and indeed contributed to Russia’s August 1998 financial crisis, but the Russian state also has to address the additional and

related problem of building functional and legitimate political institutions at the federal and regional levels and enhancing center-regional policy coordination.

Overview of the Russian Far East: The Challenge of Regional Development

Comprised of Amur Oblast, the Chukotka Autonomous Okrug, the Jewish Autonomous Oblast, Kamchatka Oblast, the Koryak Autonomous Okrug, Magadan Oblast, Primorskii Krai, the Republic of Sakha, and Sakhalin Oblast, the Russian Far East constitutes 36.4 percent of Russian territory with a population of 6.68 million¹¹—these vast territories are Russia’s gateway to the Pacific and border China, Japan, North Korea, and the United States. During the Soviet era the economy of the Russian Far East served as a key source of natural resources for the domestic market and provided necessary support for the Pacific Fleet and Far East military district. Mining, fisheries, timber, and diamonds, are the top resource sectors in the Russian Far East, which contains half of Russia’s fish resources, one-third of its hydropower, 30 percent of its coal reserves, 25 percent of its timber, and large amounts of non-ferrous and precious metals. Defense industries also play a key role in southern areas of the Russian Far East, especially Khabarovsk Krai and Primorskii Krai. Cold War era tensions in Moscow’s relations with China, Japan, and the United States, as well as the location of defense facilities in the Russian Far East served to artificially seal off these territories from the dynamic export-oriented growth emerging as the distinguishing characteristic of the economies of neighboring Asian states. Prior to 1991, 75 percent of goods produced in the Russian Far East were destined for the national market and only 6 percent was exported.¹²

In 1991–92, the Russian Far East suddenly was cut off from traditional suppliers of food products and consumer goods in European Russia due to interrupted economic links and high transportation costs. Decreased demand for goods produced in the region's defense and consumer goods industries led to a sharp drop in industrial production. As of 2000, industrial production in the Russian Far East amounted to less than 44 percent of the 1990 level (compared to 54.4 percent for Russia as a whole). Although Russia experienced an average decrease in employment of 16.8 percent from 1990-98, the Russian Far East saw a 22 percent drop. Because the cost of living is higher in this part of Russia, the standard of living of the population fell. Regions such as Khabarovsk Krai with more diverse economies reported 28.9 percent of the population living below the subsistence level (just below the national average of 29 percent), while 70 percent of Chukotka residents had incomes below subsistence. Due to the high cost of living and underemployment, the Russian Far East lost 7 percent of its population by the mid-1990s.¹³ Although the northern regions of the Russian Far East experienced the most substantial outflows, the population of Primorskii Krai and Khabarovskii Krai declined by 1.5 percent and 3.3 percent respectively.¹⁴

Traditionally, the Russian Far East depended on subsidies to attract necessary workers (who received higher than average salaries during the Soviet era), and to cover the increased costs of fuel and transportation. In the 1990s, fewer federal subsidies were available to cope with the rising costs of living and transportation, badly affecting the population and enterprises alike. High transportation costs isolated the region from the rest of the country.

During the 1996 presidential election campaign, Yeltsin unveiled a ten-year presidential program for the economic and social development of the Russian Far East and Trans-Baikal regions for 1996-2005. The initiative turned out to be an idle campaign promise—although the program was supposed to resolve many fundamental problems, such as high transportation and energy tariffs and unstable energy supplies, as well as to promote the integration of the Russian Far East in the Pacific Rim, insufficient federal funding left many of the program's goals unfulfilled. The federal budget only allocated 10.6% of projected funding for the Russian Far East in 1996-2001.¹⁵

Disillusioned by inadequate federal support, the Russian Far East began viewing economic integration in the Pacific Rim as a solution to regional underdevelopment. Initially, regional leaders focused their efforts on expanding trade and joint ventures with China. Much of the trade with China during this period was barter trade, carried out by shuttle-traders from China's northeastern provinces. By the mid-1990s regional trade partners expanded to include South Korea, Japan, and the United States—currently just 10 percent of goods produced in the regions are destined for the European Russian market. Most of the goods remain within the Russian Far East and 15 percent is exported.

¹⁶ Nevertheless, the share of the Russian Far East in Asia-Pacific trade amounts to just 0.29%.¹⁷

In November 2000, President Putin outlined his own vision of Russia's economic integration in Asia, as a supplier of advanced technology.¹⁸ Despite this grandiose vision of the region's future role in the Asian economy, Putin's new federal program for the Russian Far East through 2010 envisages a less costly, more narrowly defined blueprint for regional development. According to Pavel Minakir, director of the Institute for

Economic Research in Khabarovsk, which drafted an alternative version of the federal program, cost savings will come at the expense of key regional needs in transportation and social services and compromise ongoing projects that were counting on federal support to complement promised foreign investment.¹⁹

Since the previous program was only partially completed, the Putin plan envisages few fundamental changes. According to Khabarovsk Krai governor Viktor Ishaev, the 2002-2010 program actually provides for less federal funding, approximately \$3.6 billion annually, compared to \$4.8 billion disbursed in 1999-2001. Ishaev further noted that the portion of funds allocated to address the many social problems in the Russian Far East has been cut drastically from 6% in 1996-2001 to 0.77% in 2002-2010.

While Putin has been trying to encourage the regions to become more financially self-sufficient, as Ishaev points out, the Russian Far East is being asked to pay more for programs previously financed by the federal government, at a time when regions are entitled to keep a smaller share of their revenue and the federal share has increased. Since changes in the 2000 budget law, regions now keep only 44.1% of revenue, compared to 48.2% in 1995.²⁰ This leaves natural resources as the main source of influence and revenue for the regions, a fact very apparent to the federal authorities, which have been trying increasingly to control key resource sectors, as we will see below.

General Trends

1. Trade

The Russian Far East typically exports natural resources to its neighbors in the Pacific Rim, especially oil and gas (24.6%), timber (14%), and fish products (7.5%). Due to the

presence of defense industries in the region, machinery and equipment (a category including military technology) accounted for 44% of exports, mostly to the PRC. Throughout the 1990s, the PRC, the Republic of Korea, Japan, and the USA have been the main trading partners of the Russian Far East,²¹ although the region also has been cooperating with Canada, Australia, and New Zealand, and acquiring new partners, such as Singapore, Malaysia, India, and Taiwan.

*The Russian Far East's Top 5 Trading Partners in 2001
(In Millions of USD)*

	Exports	Imports	Total
PRC	1,716.3	170.9	1,887.2
Republic of Korea	643.9	206.5	850.4
Japan	560.4	186.1	756.5
Singapore	498.1	3.1	501.2
USA	46.6	125.9	172.5

Source: Russian Far East Customs Data, U.S. Department of Commerce

China

China is the main export destination for the Russian Far East, a position that has been hard won. At their 1996 summit meeting, Yeltsin and Jiang Zemin pledged to reach US\$20 billion in trade by 2000. This turned out to be an unattainable goal—in 1999 bilateral trade only reached US\$5.9 billion, far below the peak level of US\$7.68 achieved in 1993. In 2000, however, Sino-Russian trade reached US\$8 billion, surpassing the record turnover achieved 1993 for the first time, and in 2002 achieved an unprecedented US\$11.92 billion. During Chinese President Hu Jintao's first summit meeting with Putin

in May 2003, the two leaders pledged once again to reach a trade volume of \$20 billion, this time by 2008.

Since the signing of the 2001 friendship treaty, Russian and Chinese officials and business people have redoubled their efforts to expand economic cooperation beyond the natural resources sectors. Figures for the first 4 months of 2003 show a total turnover of \$4.5 billion, 30.3% higher than the volume reported in the same period of 2003.²² Stringent Russian measures to control SARS may restrict the growth of Sino-Russian trade in 2003, however, especially between China and the Russian Far East. On May 15, Prime Minister Mikhail Kasyanov announced the closure of 31 of 52 checkpoints along the Sino-Russian border, and delays at open stations are likely to increase due to heightened attention to health checks. The Russian civil aviation authority has advised airlines to stop selling air tickets (and even delivering cargo) to Chinese destinations to contain the spread of SARS. Currently flights only service the Beijing-Moscow route.²³

The poor reputation of Chinese goods in Russia has been a significant obstacle to increased trade, although Chinese exports have fared better since the 1998 Russian financial crisis made higher-quality imports from other countries prohibitively expensive. China set up two trade centers in Moscow to showcase Chinese consumer goods and plans to set up a third in Khabarovsk. Nevertheless, as long as Russian traders continue to sell bottom-of-the line goods from Northeast China, shoppers in the Russian Far East will be reluctant to shed their stereotypes of low quality Chinese goods.

Problems in regional economic relations have proven to be difficult to resolve since they reflect the legacy of underdevelopment still plaguing the Russian and Chinese border regions two decades after their reopening to cross-border economic relations.²⁴

Progress will depend, to a large extent, on the fate of economic reform in the Russian Far East and the Chinese Northeast. In the interim, Russian and Chinese officials have been working to improve the regulation of regional economic ties, for example, by signing inter-bank agreements facilitating regional transactions. A pilot project to use Russian and Chinese national currencies in border trade was just introduced in the Amur region. They also have been trying to reach beyond cross-border cooperation, by encouraging China's more developed southern regions to expand economic contacts with the Russian Far East and promote cooperation between scientific centers in Siberia and China's Northeast.

Sino-Russian military cooperation has proven to have important economic payoffs for the Russian Far East—entire factories have been kept afloat to cater exclusively to Chinese military contracts. The Komsomolsk-na-Amure aviation plant in Khabarovsk Krai, for example, has been the main supplier of SU-27 fighter aircraft for China. Three factories in the beleaguered military-industrial complex in Primorskii Krai, will supply electronics and anti-ship missiles for the two additional destroyers China agreed to purchase in January 2002.

South Korea

As South Korea emerges from the Asian financial crisis, there are signs of heightened interest in the Russian market. A new South Korean Embassy building will open in Moscow in September 2003 and plans for an enormous Lotte department store in the capital, some five years in the making, are now moving forward.²⁵ Since the mid-1990s, as dissatisfaction with Chinese imports has grown, residents of the Russian Far

East increasingly have looked to South Korea as a source of higher quality consumer goods. However, the 1998 financial crisis in Russia led to a drop of more than 40 percent in South Korea's trade with Russia. Total trade turnover remains small, amounting to \$3.27 billion in 2002.²⁶ Some smaller South Korean firms had to pullout of the Russian market when their partners failed to pay them for goods sent before the crisis. Despite this, the Korea Trade Center (KOTRA) continues to maintain an office in Vladivostok and the Russian Far East remains a strong market for South Korean electronics, food products, and construction supplies.

North Korea

Trade between the Russian Far East and North Korea has been fairly stable throughout the 1990s, reflecting Pyongyang's dependence on the region's exports of food products and timber. Currently 70% of North Korea's trade is with the Russian Far East, although the actual turnover remains modest. Primorskii Krai, which borders on North Korea, has reported \$2-3 million in annual trade with its south neighbor during the past five years.²⁷ Prospects for increasing trade will depend above all on the improvement economic situation in North Korea.

Japan

In recent years, Russia and Japan have taken a series of steps to improve their economic cooperation, for example, by signing a program in September 2000 to deepen trade and economic relations, sending a Nippon Keidanren delegation to Russia in June 2001, and developing a Japan-Russia action plan in January 2003.²⁸ Japan is an important export destination for the Russian Far East as a whole. Leading Russian exports to Japan

include non-ferrous and precious metals, timber, fish products, and fuel. While there is considerable interest in importing Japanese consumer products, their relatively higher cost compared to South Korean and American products has restrained demand. Second-hand used cars have been the most popular imports from Japan to the Russian Far East, but new Russian import duties imposed as of October 2002, will increase the price threefold from \$1000 and make the automobiles too expensive for the average consumer. In 2002, Japanese imports from Russia fell, causing a 5% drop in overall trade turnover to \$4.4 billion.

Japanese prefectures bordering on the Sea of Japan have been pressing for greater economic relations with the Russian Far East. Niigata has been active in establishing ties with Primorskii Krai, and Hokkaido has a permanent representation office on Sakhalin. The establishment of regional organizations, including the association of governors from Japan and the Russian Far East and the Russian Far East-Hokkaido association, has facilitated the growth of Russian-Japanese regional relations. To facilitate trade and economic cooperation between Japan and the Russian Far East, JETRO and the Japan Association for Trade with Russia and East Central Europe established training centers for small and medium-sized enterprises in key regions in the Russian Far East.

2. Investment

Despite its vast resource potential, the Russian Far East has lagged behind other regions in Russia in terms of foreign investment. Although the Russian government predicts that by 2004 investment in the Russian Far East will grow by 90% from 2000 levels, as oil and gas projects in Sakhalin and Sakha proceed, even so the Russian Far

East would account for just 7% of total Russian investment. In 2001, the Russian Far East received \$767 million in total foreign investment.

*Foreign Investment in Key Regions in the Russian Far East
(In Millions of USD)*

Region	2000	2001
Sakhalin	251	388.9
Sakha	160	144.6
Primorskii Krai	78	108.6
Kamchatka	29	78.4
Khabarovsk Krai	27	19.9

Source: Association for the Russian Far East and the Trans-Baikal, U.S. Department of Commerce

South Korea

Despite some initial difficulties, some of the largest South Korean investments in Russia are in the Russian Far East. One of the earliest ventures was the Hyundai timber project in Svetlaia in Primorskii Krai. After encountering fierce local and international opposition because of its adverse impact on the ecology of local forests, the project was abandoned. South Korea's participation in a technopark in Nakhodka took more than a decade to arrange because of wrangling over special economic zone (SEZ) legislation in the Russian State Duma. The project's development was complicated further by allegations of corruption and political infighting between the Primorskii Krai governor and his main rival, Sergei Dudnik, the former administrator of the zone. Finally SEZ legislation was passed in December 1998, and in May 1999 the Russian and South

Korean governments signed an agreement to move the project forward. The size of the technopark has been scaled down considerably, from 330 to 20 hectares. The Korea Land Development Corporation will lease the site for 49 years to build infrastructure and facilities, which will be rented to Korean firms.²⁹

In the late 1990s, some South Korean clothing manufacturers began purchasing controlling shares in factories in Primorskii Krai to take advantage of Russia's unused textile export quotas. For example, a South Korean apparel factory employing 600 was set up in Partizansk to produce clothes for the American market. Although many residents welcomed the new source of employment (where low wages were at least paid on time), some criticism of sweatshop conditions developed.

South Korea has been willing to weather considerable difficulties with its projects in the Russian Far East because of the important strategic, political, and economic interests at stake. Seoul's investment in the region has been directed to Primorskii Krai, the region bordering on North Korea. Not surprisingly, Hyundai, a major supporter of Kim Dae Jung's "sunshine policy," is the largest investor. Although its timber venture failed, the corporation also has invested \$90 million in a hotel and business center in Vladivostok. As a means of facilitating North Korea's economic integration in Northeast Asia, South Korea has played an active role in promoting regional development. Shippers have explored a variety of transit trade projects. In the spring of 2000, three new car ferry routes and one new container route opened, linking South Korea, China, and Primorskii Krai. South Korea also has supported efforts to develop infrastructure and tourism in Primorskii Krai, Jilin province in Northeast China, and the Rajin-Songbong

Economic Zone in North Korea as a part of the United Nations Development Program's Tumen River Area Development Program (TRADP).

Officials in Primorskii Krai originally had a negative attitude toward the project, which they feared would lead to the construction of new ports in China that would take business away from Zarubino, Pos'et, Vladivostok and Nakhodka, and irreparably damage nearby Russian nature preserves. Controversy over Sino-Russian border demarcation in the Tumen region also contributed to opposition in Primorskii Krai. However, Russia and China reached a compromise over the Tumen area border demarcation and the United Nations Development Program decided against building any new Chinese ports, although other infrastructure improvements have been made, including the reopening of the Tumen River bridge connecting China and North Korea at Wonjong/Quanhe, and the construction of a railway linking the Chinese city of Hunchun with Kraskino in Primorskii Krai. Officials from China's Jilin province recently have been pressing Primorskii Krai authorities to grant them a 49-year leasehold on the ports of Poset' and Zarubino to facilitate their coal exports to the Japan and the U.S. West Coast. However, Russian officials oppose leasing the ports, now controlled by Russian companies, to foreign interests.³⁰

North Korea

Some small joint projects between North Korea and Primorskii Krai in seaweed processing have been progressing, but more elaborate collaboration has proved difficult to implement due to a lack of financing. In 1996, the Nakhodka Special Economic Zone (SEZ) and the Rajin-Songbong FEZ signed an agreement to explore joint activities in

areas such as the forestry sector, but little has developed despite strong support from officials such as former Nakhodka SEZ director Sergei Dudnik, now a deputy in the Primorskii Krai Duma.

While prospects for major bilateral projects remain limited, tripartite cooperation in the energy sector, involving South Korea or China, is promising. Russia's Far East Managing Energy Company (DVUEK) has been exploring a project to supply electrical power to China and North Korea.³¹ Moreover, Russia and South Korea have been discussing the feasibility of connecting a possible gas pipeline from Kovykta in east Siberia (discussed below) through North Korea to Pyongyang, south of Seoul.³²

Japan

In the Russian Far East there is considerable interest in attracting Japanese investment, a goal frustrated to some extent by the lack of significant progress in bilateral issues. As Sino-Russian relations drew closer in the mid-1990s, Japan began to seek ways of moving forward with Russia, too. Since Prime Minister Hashimoto outlined the new "Eurasia Policy" in 1997, Japanese officials have focused on the Russian Far East in their effort to boost Russian-Japanese economic relations. In this effort, Japan has established cultural centers, providing free Japanese lessons and business advice in many cities in the region and has established consulates in Vladivostok, Khabarovsk, and Yuzhno-Sakhalinsk. In addition, the Japanese government has provided humanitarian assistance to hospitals in the Russian Far East and has undertaken a program of assistance with the dismantling of nuclear submarines. Japanese officials have put together a list of projects in the region that may interest Japanese investors. In an effort to facilitate

investment in the region, a branch of Michinoku Bank, one of Japan's largest, plans to open in Khabarovsk in the summer of 2003.

A political scandal involving Muneo Suzuki, a Japanese member of parliament, and his associate, Masaru Sato, leaders of the "Russian Group" in the Japanese government, the group favoring a speedy compromise on the Kurile islands dispute, has led to a reexamination of Japanese assistance to Russia due to allegations that some aid projects for the Russian-held Kuriles were subject to political influence-peddling and bribe-taking in Japan. Japanese auditors also have been examining the lack of progress in a nine-year old program to help dismantle nuclear-powered submarines in the Russian Far East and to build a nuclear waste storage facility.

In the Russian Far East, attracting Japanese investment is an important priority. Infrastructure development has been a key area for cooperation. Japan has participated in the renovation of airport terminals in Vladivostok, Khabarovsk, and Yuzno-Sakhalinsk. Japan also contributed \$30 million to a feasibility study investigating improvements for the port of Zarubino. In May 1999, the Primorskii Krai administration and the Japanese-Russian Business Committee signed an agreement according to which Japan will invest \$10 million to build new facilities for grain storage, wood chip processing, and container transshipment.

In the aftermath of the 1997 Kyoto meeting on reducing greenhouse emissions, several Japanese firms, including Sumitomo, Mitsubishi, and Mitsui, began exploring the possibility of investing in renovations of power plants in Primorskii Krai, Khabarovskii Krai, and Sakhalinskaia Oblast. Seven projects were identified but no final decisions leading to feasibility studies have been made yet. In an effort to reduce nuclear waste in

the Sea of Japan, Tokyo invested \$40 million in a floating low-radiation liquid waste-processing complex at the Zvezda facility in Bolshoi Kamen, a submarine base in Primorskii Krai. The facility, which became operational in November 2001, will treat 5,000 cubic meters of liquid radioactive waste annually.

Japan is the leader in terms of the number of joint ventures established on Sakhalin and also has a number of successful joint ventures in timber in Primorskii Krai and Khabarovskii Krai. The Ternowood joint venture in Primorskii Krai has been described as a “miracle” due its success in producing high-quality construction materials at Japanese standards.³³ The Tairiku timber project near Sovetskaia Gavan’ in Khabarovskii Krai reportedly is one of most sophisticated manufacturing operations in the region, involving the production of kiln-dried pine for the Japanese market exported via Vanino. Mill waste from the project is used for power generation for the sawmill and nearby villages.

Despite these successes, many obstacles stand in the way of economic cooperation between Japan and the Russian Far East. Japan’s determination to recover the southern Kurile Islands is at the root of many Japanese efforts to become more involved economically in the Russian Far East. In fact, Japan is most active in Sakhalin, the region administering the Kuriles. Nonetheless, due to the continuing impasse over the islands, the Japanese government refuses to allow Japanese firms to invest in the Southern Kuriles and discourages other foreign investment. Japan protested Russia’s decision in December 2000 to allow South Korean boats to fish in the waters around the southern Kuriles from August-November 2001. When talks with South Korea failed to resolve the issue, Japanese authorities retaliated by banning South Korea from fishing in

its economic zone, prompting a tit-for-tat response from Seoul. South Korea stands to earn \$23 million from the 15,000 tons of fish they are allowed to catch in the waters near the disputed islands.

As stated earlier, although the Kuriles issue makes headlines the greatest obstacle to Japanese investment in the region is the high level of risk. High profile failures of joint ventures between Japan and Russia in Khabarovsk and Yuzhno-Sakhalinsk have given prospective investors in Japan considerable pause. For this reason, some Japanese companies are seeking to participate in U.S.-Russian projects as a way of lowering their individual risk. Participation by major Japanese conglomerates in the Sakhalin projects, along with American, European, and South Korea firms, is a clear example of this strategy. Smaller Japanese companies also have chosen to buy logs from U.S.-Russian joint ventures as a way of ensuring a more stable supply than could be purchased from Russian companies.

United States

Beginning in the 1990s, U.S. West Coast businesses became interested in developing Russian resources, and their counterparts in the Russian Far East sought to import American consumer products and machinery. The state of Alaska, in particular, took the lead in developing partnerships with businesses, NGOs, and indigenous groups in the Russian Far East, and now has particularly close ties with Sakhalin and Chukotka.

In 1994, interaction between the U.S. West Coast and the Russian Far East acquired an institutional basis under the framework of the Gore-Chernomyrdin Commission on U.S.-Russian cooperation. The Ad Hoc Working Group was established

as a part of the Commission's Business Development Committee to coordinate the cooperation between states in the U.S. West Coast and the Association for the Russian Far East and the Trans-Baikal. Although in July 2001 the Bush Administration chose to replace the inter-governmental framework with a new bilateral business initiative, the Russian-American Dialogue, the Russian Far East and U.S. West Coast partner organizations have continued to hold regular meetings in an effort to promote U.S.-Russian regional economic ties in a wide range of spheres, including forestry, fishing, energy, and transportation. To expand membership to regions and states inland from the two coasts, the group was recently renamed the Russian-American Pacific Partnership.

Apart from the Sakhalin oil and gas projects (discussed below), other major U.S. investments in 2001 include gold mining in Magadan, oil and gas in Sakha, timber in Khabarovsk Krai, and defense conversion, communications, fishing, and transportation in Primorskii Krai. The largest U.S. investment in Primorskii Krai is the Coca-Cola bottling factory in Vladivostok. A total of \$100 million has been invested in the plant.

Successful U.S.-Russian projects include Clear-Pac, which has developed automated customs clearance mechanisms in Vladivostok and Sakhalin, and a pilot project to develop the coastal fishing fleet.

Key Sectors

1. Energy

Sakhalin's offshore oil and gas projects have attracted the largest U.S. investments in the Russian Far East and the territory is second only to Moscow as a destination for U.S. capital. Thus far, these energy projects have drawn in \$1.67 billion in investment. Planned infrastructure development for the Sakhalin-1 and Sakhalin-2

projects (the first two of the seven projects on the island to begin operations), including the construction of a trans-island pipeline, a liquefied natural gas plant and terminal, are expected to bring in \$1 billion in investment by the end of 2003, according to Sakhalin Oblast Governor Igor Farkhutdinov.

In October 2001, Exxon Mobil announced that the Sakhalin-1 project was profitable and outlined the company's plans to invest \$30 billion by 2030. According to the Association for the Russian Far East and the Trans-Baikal, the United States could invest more than \$40 billion in Sakhalin's offshore oil and gas over the next several decades. Current tensions in the Middle East have increased U.S. interest in energy projects in Russia. During the May 2002 summit meeting, for example, Presidents Bush and Putin discussed prospects for stronger energy links between the two countries.

The oil projects are governed by production-sharing agreements (PSAs), providing for the transfer of foreign technology and development techniques in exchange for royalties and resources. For the projects to move forward, the PSAs must be approved by the State Duma, which then must enact enabling legislation. In response to persistent complaints by foreign oil companies and Sakhalin Oblast officials about costly delays in this process, Putin attended a September 2000 conference on the island to show his support for the PSA process, often a target of criticism in Moscow. In a measure designed to streamline PSA approval and implementation, he entrusted his Minister for Economic Development and Trade, German Gref, with coordinating the process. The decree authorizing Gref's new role was not signed until February 2001, however, and foreign businesses and Sakhalin officials now claim that Putin's changes actually created more confusion by interrupting established lines of communication. To remedy

the situation, in October 2001 Gref put two companies (Rosneft and Zarubezhneft) in charge of PSA approval and preparation.

Foreign Investment in Sakhalin Projects

Project	Investors	Estimated
Investment Total		
Sakhalin 1	ExxonMobil (USA) 30% SODECO (Japan) 30% ONGC Videsh Ltd. (India) 11.5% SMNG-Shelf (Russia) 11.5% Rosneft-Astra (Russia) 8.5%	\$12 billion PSA in place In production
Sakhalin 2	SEIC (USA) and Mitsui (Japan) 25% Royal Dutch Shell 55% Mitsubishi (Japan) 25%	\$10 billion PSA in place In production
Sakhalin 3 (Kirinskii block)	ExxonMobil (USA) 33.33% Chevron Texaco (USA) 33.33% Rosneft (Russia) 16.67% SMNG (Russia) 16.67%	\$151 million in exploration costs
Sakhalin 3 (Ayashinksii and E.Odoptinskii Blocks)	ExxonMobil (USA) 66.66% Rosneft (Russia) 16.67%	\$380 million in exploration costs
Sakhalin 4	BP (UK) 49% SMNG (Russia) 16.67% Rosneft (Russia) 25.5% Rosneft-SMNG (Russia) 25.5%	Not yet defined
Sakhalin 5	BP (UK) 49% Rosneft (Russia) 25.5% Rosneft-SMNG (Russia) 25.5%	Not yet defined
Sakhalin 6	Alfa Group (Russia) proposed developing one field without a PSA. Alfa Eco (Russia)	Not yet defined

and Petrosakh (Russia) have the license for the field adjacent to the Okruzhnoye onland field.

Source: BISNIS, U.S. Department of Commerce, August 2002

Russian and Chinese leaders see the energy sector as one of the most promising for expanding economic cooperation. China's energy consumption has been rising rapidly, resulting in an increasing dependence on oil imports—in 2001 China imported 36.9% of the oil it consumed. In light of recent Middle East tensions, China has become concerned about ensuring reliable energy supplies and has sought to diversify its suppliers outside the region.

In 1999, the Russian firm Yukos shipped 1.5 million tons of oil by rail to China and plans to sell up to 10 million tons by 2005. China already purchased oil from Sakhalin and has expressed interest in purchasing gas from the region in the future. During their July 2001 summit, Russian and Chinese leaders reached an agreement paving the way for a feasibility study for a 2,400km pipeline, running from Angarsk in eastern Siberia to Daqing in northeastern China, and costing \$1.7-\$3 billion. Although the Russian pipeline monopoly, Transneft, had promoted an alternative pipeline, favored by Japan, which would ship oil from Angarsk to Nakhdoka in the Russian Far East and then to the Japanese and Korean markets, in April 2003 Prime Minister Kasyanov indicated his support for Angarsk-Daqing project, preferred by China (and oil giant Yukos). The Angarsk-Daqing pipeline could be built as early as 2005 and begin shipping 20 million tons annually to China from 2005-2010, and then 30 million tons per year from 2010-2030. China's National Petroleum Corporation agreed to finance 50% of the Angarsk-Daqing project through loans to be repaid with oil revenues, while Japan, now

in fierce competition with China, has pledged \$5 billion in credits to finance the 3,765 km Angarsk-Nakhodka pipeline and another \$1 billion in investments in the Russian Far East.³⁴

The Russian state gas monopoly Gazprom also joined a consortium led by Royal/Dutch Shell Group to lay a 4,200 km gas pipeline from Xinjiang to Shanghai. For the past five years Russia and China have been discussing the feasibility of constructing a gas pipeline from Kovytka in Eastern Siberia to China, but Chinese experts have questioned Russian reserve estimates and proposed a price unacceptable to the Russian partners. According to some analysts, Russia tends to overestimate China's current capacity to absorb natural gas from Siberia in the Russian Far East and its interest in doing so, especially given the Chinese leadership's priority on developing its own domestic resources, amounting to 10 trillion cubic meters. At present China continues to rely mainly on coal, with oil accounting for 20% and gas for just 2% of its energy needs.

Although China's overall energy consumption is rising, the industrial decline in China's Northeast has lowered energy demand in areas contiguous to Russia. In September 2000, after three years of talks, China rejected a multi-billion dollar project by Russia's Unified Energy Systems to build an electrical grid, which would have transmitted 10 billion kilowatt-hours of electricity to northern China over a 20-year period.

While China has been considering a range of oil and gas projects with Central Asia and Russia, their high cost, compounded by disputes over reserve estimates and routing, has resulted in slow process. Moreover, Chinese policymakers are wary of

excessive dependence on Russia, given the dire consequences of Moscow's abrupt termination of economic cooperation in the 1960s when Sino-Soviet friendship turned sour. China's most recent major gas contracts, for example, have been with Australia and Indonesia. As a result, there has been much more discussion about Sino-Russian energy cooperation than concrete progress.

In the early 1990s South Korean businesses were overly optimistic about the prospects for Korean-Russian economic cooperation. Economic crises in South Korea in 1997 and in Russia in 1998 served to scale back original expectations. Over the long term, South Korea's most significant economic interest in the Russian Far East is likely to be energy. In fact, the Sakhalin-2 project's first shipment of oil went to South Korea. Seoul is a prospective market for natural gas from all of the Sakhalin projects, and the construction of a pipeline from Primorskii Krai to South Korea is under discussion.

Japan is viewed as one of the main potential markets for LNG from Sakhalin. The Tohoku Electric Power Company agreed to long-term contracts for LNG to be produced by Sakhalin 2 at a new gas liquification facility on the island. Western investors in Sakhalin 1, such as Shell and Exxon, support the construction of a gas pipeline from Sakhalin to Japan, although the Russian government favors pipelines connecting the island to mainland Russia. The Japan-Sakhalin Pipeline Corporation completed a feasibility study for a pipeline running from Sakhalin to Hokkaido, but western investors still need to establish whether Russia would grant them equal access to any new pipeline and must line up sufficient long-term contracts.

Japan was one of the early investors in the Sakhalin offshore oil and gas projects. Sodeco has a 30 percent share in Sakhalin-1, and Mistui and Mitsubishi hold a 45%

percent share in Sakhalin-2 (Mitsui -25%, Mitsubishi-20%). All of the options for delivery of Sakhalin's natural gas target the Japanese market. Plans under discussion include the aforementioned liquefied natural gas facility on Sakhalin, which would ship the product to Japan; an underwater power grid connecting Japan to Sakhalin; a gas pipeline from Sakhalin to Hokkaido; and even a tunnel linking Sakhalin to Hokkaido, which could transport oil and gas and also provide underwater rail and road connections between the island and Japan.

2. Transportation

At their 2000 summit the two Koreas decided to restore the inter-Korean railway, which could be connected to the Trans-Siberian railroad or to rail lines in China, thereby opening up significant new possibilities for shipping from Northeast Asia to Europe by rail, or by sea to the U.S. Pacific coast, and for attracting potential investors to the Tumen region. Agreements concluded between North and South Korea in 2002 led to the resumption of work on the western (Gyeongui) inter-Korean rail line, which would link Busan, Seoul, and Pyongyang by 2010, and then could be extended north to China and Russia.

In preparation for the new inter-Korean railway, the Russian Ministry of Railways has allocated funds for the modernization of a 240km rail link connecting Khasan, across the border from North Korea, with Ussuriisk on the trans-Siberian railway. In an effort to boost shipping along the trans-Siberian, now only used at 50% of capacity, Russia had been advocating an eastern route (the Donghae line), which would run along the eastern coast of the Korean peninsula and eventually connect to Khasan in the Russian Far East.

Because the Donghae line would run through an inaccessible mountainous area, now Russia and North Korea are exploring a third possibility, the Kyongwon route, which would run through the middle of the peninsula, northeast to Wonsan in North Korea.

Russian officials hope that the completion of the inter-Korean railway would lead to a more than tenfold rise in shipping along the Trans-Siberian, from 45,000 containers per year to 500,000 to 600,000 annually. Nevertheless, while a new link from the inter-Korean rail to the trans-Siberian could shorten shipping time for western-bound cargo, making rail transport competitive with currently used marine shipping routes, time savings could be offset by delays at the Sino-Russian or Russian-North Korean borders where trains must change gauges.

Moreover, some officials in Primorskii Krai are opposed to the link between the Trans-Siberian railroad and the inter-Korean railway because they claim that only the Moscow-based Ministry of Railways would benefit and are concerned that the new rail connection would have a detrimental impact on regional ports, which depend on South Korean cargo, now shipped by sea.³⁵ Officials in the Russian Far East complain that central government policies, which allocate special customs privileges to certain individuals and companies in Moscow and St. Petersburg, thereby creating a duty-free route or “black corridor”, already divert Asian shipping from Russian Far east ports.

2. Labor

Chinese officials view labor exchanges as a key component of economic cooperation between China and Russia. According to the Chinese view, the Russian and Chinese economies are complementary: Russia has the land and resources that China

lacks, while excess Chinese labor could compensate for an increasing shortage of workers in some sectors in Russia. Labor exchanges between Russia and China have proven to be highly controversial, however, due to Russian concerns about Chinese illegal immigration and perceptions of demographic pressure from China.³⁶

The rapid expansion of border trade with China in 1992–93 was a major adjustment for the Russian and Chinese border regions, largely closed off for security reasons for almost three decades. For example, in 1988 only 6,233 border crossings were reported in Amurskaia oblast, a land-locked region bordering on China, but in 1992 there were 287,215 crossings, and the region’s imports and exports were oriented almost entirely to the Chinese market.³⁷ According to the USSR’s 1989 census, there were just 784 Chinese officially resident in the Russian Far East.³⁸

From 1991 to 1993, enthusiasm for “opening to the north” by far outpaced measures to regulate border trade. Many inexperienced firms participated in the mad rush to the border, leading to vociferous complaints in the Russian Far East about shoddy goods and unscrupulous Chinese traders. Chinese traders also accumulated their own list of complaints about the difficulties of doing business in Russia due to the unstable economic environment and pervasive corruption.

After two years of visa-free border trade, visas were once again required as January 1, 1994, leading to a 34% drop in the Sino-Russian trade balance in 1994. New restrictions also were imposed on the use of foreign contract labor in Russia for construction and agriculture, and regional authorities in the Russian border regions began conducting police sweeps of markets and tour companies in search of illegal Chinese migrants.³⁹ Chinese officials in Beijing have been supportive of measures to regulate

border trade. They have protested vigorously against Russian allegations that Beijing promotes illegal immigration. Indeed, criticism of provincial authorities in Heilongjiang for inadequate administration of border trade was a factor in leadership reshuffling in the province in 1996 and led to such sharp restrictions on the issuance of passports for foreign travel that businesspeople complained of difficulty in going about their work.⁴⁰ Moreover, Chinese authorities have faced similar problems of criminal activity by Russians living in China and implemented a well-publicized campaign against illegal border crossings. At the same time, Chinese leaders have expressed concern that efforts to prevent illegal immigration could harm the rights of law-abiding Chinese citizens who are legitimate businesspeople or tourists in Russia.

In response to Russian complaints, Chinese tourists are only allowed to remain in Russia for a maximum of three months. According to a former official in the Chinese consulate in Khabarovsk,⁴¹ Russian enforcement of this time limit is lax. Instead of requiring that Chinese who overstay their visas leave Russia immediately, local officials demand regular “payments,” thereby creating a mutually beneficial criminal situation, allowing Chinese to remain beyond their allowed time limit, while providing a source of regular illegal income for Russian officials. This practice would explain how Russian officials simultaneously claim that 99% of foreign tourists (the majority of whom come from China) now return within their allowable time frame, while continuing to warn about the threat posed by Chinese illegal immigrants.⁴²

While Chinese policymakers have taken steps to encourage legal labor exchanges, they consistently deny Russian allegations that China is promoting illegal immigration.

During Jiang Zemin's first visit to Moscow in September 1994, he defended China's policies in the border regions and stated that he hoped that Russia "would protect the legitimate rights and interests of Chinese citizens who are engaged in normal trade and other activities. The Chinese leader stated his opposition to illegal immigration and attributed concerns over the issue to the inadequate preparation on both sides to the opening of the border."⁴³ Jiang noted that he and Russian President Boris Yeltsin had agreed to continue to develop regional cooperation despite these problems, "rather than giving up eating for fear of choking, as the Chinese saying goes."⁴⁴

The issue of Chinese migration to the Russian Far East has remained on the bilateral agenda, although both Russian and Chinese leaders have done their best to minimize its impact. The July 16, 2001 Sino-Russian Treaty of Friendship, Good-Neighborliness and Cooperation commits both parties to create an atmosphere of trust and cooperation in the border regions (article 2) and cooperate in combating illegal immigration (article 20).⁴⁵ At an October 18 press conference, Russian Foreign Minister Igor Ivanov stated unequivocally "there is no Chinese expansion." He noted that there are 150,000-200,000 Chinese living in Russia on a more or less permanent basis, a relatively small number compared to the 6 million residing in the United States.⁴⁶ Although there has been discussion of projects to make use of China's abundant labor in resource and construction industries in the Russian Far East, which have a labor shortage, public concern in Russia about the illegal migration of Chinese workers has severely limited such labor exchanges, and Russia has been resisting Chinese demands that it open up its labor markets as a condition of WTO entry.

The use of North Korean contract labor in the Russian Far East has proven to be less controversial because of the strict controls imposed on these workers by the North Korean government. Khabarovskii Krai has been using North Korean labor in the timber industry as far back as 1967: approximately 15,000 to 20,000 North Korean workers participate in these projects every year.⁴⁷ Beginning in the 1990s, North Korean farm workers were hired to work in the agricultural sector in Amur Oblast, Sakhalin Oblast, and Primorskii Krai.⁴⁸ Concerned that farm labor would provide a pretext for illegal migration by Chinese farmers, regional officials prefer to hire North Korean workers, whose contracts are enforced more strictly.⁴⁹ Primorskii Krai officials had additional cause to be pleased with North Korean labor since some of the contract workers sent to the region reportedly worked for free, as partial repayment of North Korea's outstanding debt to Russia.⁵⁰

As is the case with Russian-Chinese regional relations, Russia's regional relations with North Korea have added many problems to their bilateral agenda.⁵¹ The press in Khabarovsk and Vladivostok often reports on the involvement of North Koreans in counterfeiting and poaching. Because some of the North Koreans working on Russian contracts are not paid until they return home, they often undertake illegal second jobs. Local residents view their moonlighting positively when they work as private contractors, for example, and provide inexpensive, efficient assistance with home renovations. However, there are also have been allegations of North Koreans participating in drug trafficking in Russia. At least 14 employees of the North Korean timber project in Khabarovsk, who turned out to be intelligence agents, were arrested for engaging in the heroin trade.⁵²

The logging camps have been controversial on human rights grounds, as well. Especially in the first half of the 1990s, pro-Western officials in Moscow argued that the camps should be closed, but Khabarovsk authorities urged their continued operation, due to the importance of a steady supply of cheap labor for the beleaguered timber sector.⁵³ After reports of workers housed in prison-like conditions and deprived of their passports, the Russian-North Korean agreement governing the timber projects was renegotiated so as to provide local officials with greater oversight and a larger share of the harvest (61.5% instead of 43%).⁵⁴ Although there was some speculation in the Russian media following the August 2001 Russian-North Korean summit that Pyongyang was allowed to write off \$50 million of the debt by providing free labor to timber camps in the Russian Far East, the Russian Foreign Ministry denied the existence of any such formal arrangement.⁵⁵

New Economic Horizons

The Russian Far East has been steadily expanding its horizons and reaching far and wide in the Pacific Rim in its quest for economic partners. Although China, the Koreas, Japan, and the United States, have been the region's principal partners for more than a decade, the Russian Far East also has been cooperating with Canada, Australia, and New Zealand. Since the late 1990s, the Russian Far East has been expanding economic ties with Southeast Asian countries such as Singapore and Malaysia. In August 1999, Prime Minister Mohamad Mahathir visited Khabarovsk Krai, where Malaysia has a major investment in the timber industry. Singapore has become an important trading partner for some regions, exporting food products and importing resources.

After acquiring a share in the Sakhalin 1 project, India has been actively seeking additional investment opportunities in the Russian Far East. The Indian government invested \$2 billion in the Sakhalin 2 project; launched a diamond-cutting venture in Primorskii Krai in September 2002; and has been exploring other potential projects, including establishing joint ventures in pharmaceuticals with Russian scientists from the Far Eastern branch of the Russian academy of sciences, and contracting KA-52 helicopters and Bagire fire control radar systems produced in Primorskii Krai. The region's ailing shipbuilding plants have just received a contract to repair Indian warships and submarines and the port of Vostochniy will be used to ship coking coal bound for India.

Moreover, since the September 2002 APEC investment meeting in Vladivostok, Taiwan has been exploring investments in Primorskii Krai's tourism industry. While Russia has always been committed to a one-China policy, regional leaders are dissatisfied with the level of PRC investment and have welcomed Taiwan's recent interest in the Russian Far East. The Taiwanese delegation to the APEC meeting included the highest level government official ever to visit Russia, Chang Chun-hsiung, secretary-general of the ruling Democratic Progressive Party, who heads the newly founded Taiwan-Russia Association.

Obstacles to Regional Integration: Corruption, Crime, and Political Risk

Attracting significant foreign investment has proven difficult in the Russian Far East, with the exception of Sakhalin, due to perceived high levels of political risk, onerous regulations, lack of transparency, and crime. Although regional officials hoped

that the holding of an APEC investment conference in September 2002 would call attention to investment opportunities in the Russian Far East, a spate of contract killings of regional officials and business people around the time of the international meeting only served to reinforce the region's reputation as Russia's "Wild East." As if to dramatize the risks involved in investing in the Russian Far East, just one month after the APEC conference, in October 2002, a lawyer working for the Vladivostok mayor's office, and an opposition politician in the Primorskii Krai port of Nakhodka were severely injured in attacks believed to be attempted murders; Nakhodka businessman Viktori Aksinin was shot dead at his apartment door; and Vladimir Tsvetkov, governor of the gold-rich Magadan Oblast, was gunned down in Moscow.

Plentiful resources, weapons depots, ports, and a thriving business in fake identity cards and passports have made the Russian Far East especially attractive to criminal gangs. Crime and corruption are interrelated problems in the region, where rent-seeking federal and regional officials and an onerous system of resource management create incentives to siphon off resources in collusion with Russian and foreign criminals. The Russian mafia reportedly cooperates with the Japanese yakuza in a thriving trade in stolen Japanese cars (valued at \$2 billion annually) and works with Chinese criminal groups to illegally export 1.5 million cubic meters of timber annually (at a price tag of \$300 million). According to the World Wildlife Federation, more than half the timber exported to Japan from the Russian Far East is produced illegally and the share of illegal timber is equal to or perhaps greater than the legal trade.

Illegal fishing is one of the most serious problems facing the Russian Far East, which, at the end of the 1980s supplied half of the Soviet catch. For example, illegal

exports of king crab, one of the most lucrative but dwindling shellfish variety, amounted to \$188 million. By some estimates illegal fishing and unreported fish exports accounted for two-thirds of the Russian Far East's revenue from fishing in the 1990s. Overfishing and illegal sales of fish have depleted fish stocks, but, given the pervasive criminality in this sector, one of the few in the Russian Far East to attract significant foreign investment, efforts to regulate fishing more strictly face considerable opposition from entrenched interests. At times new regulations have resulted in deadly retaliation: not long after the commander of Sakhalin's border guards ordered all small fishing vessels to install tracking equipment, in an effort to crack down on smuggling to Japan, he was killed in an arson attack at his home.

The port city of Vladivostok now boasts Russia's sixth highest crime rate. In this city Chechen gangs allegedly run several major smuggling operations in fishing and stolen cars. Since 1998, when Iran closed its border with Afghanistan and Western drug interdiction agencies cracked down on the flow of heroin from Central Asia to Europe, Central Asian drug smugglers began moving their operations to Vladivostok, as evidenced by rising heroin addiction, falling prices for the drug, and increasing instances of drug-related crime.

Those foreign investors willing to put up with the high political risk in the Russian Far East to pursue lucrative ventures have found that, despite regional interest in bringing in foreign investment, such cooperation can be controversial in the Russian Far East due to concern about the implications of foreign control, especially by western business interests.⁵⁶ In June 1999, for example, former Primorskii Krai Governor Evgenii Nazdratenko asked the Federal Security Bureau to investigate the business

dealings of Andrew Fox, a British investor and Britain's honorary consul, who was serving on the board of the Far Eastern Shipping Company. Fox alleged that Nazdratenko threatened to put him in jail unless he turned over 7 percent of the shares owned by foreigners. Fox, whose firm, Tiger Securities, had brought \$30–40 million in investment into Primorskii Krai, fled to Britain. The case sparked a regional media campaign assailing foreign efforts to take over shipping companies. While the governor earned political capital from the campaign in the months leading up to the elections in December 1999, his administration quietly reassured U.S. consular officials of the region's continued interest in attracting American investment.

The investment climate appears to have improved little under the new governor, Sergei Darkin, as the experience of Henri Bardon's Eurasia-Holdings with what he termed "jungle capitalism" attests. After investing \$12 million in the region's main grain company, which one time provided 75% of local flour and 100% of animal feed, U.S.-based company, Euro-Asia Holdings now finds itself the proud owner of 20% of a bankrupt company. The company's assets were sold off in March 2002 without compensating foreign investors, despite a court order to pay the U.S. company \$6 billion.

Even in Sakhalin, where multinational firms have great hopes and deep pockets, Dinty Miller, the senior BP representative characterized the opportunities as "once in a lifetime but very risky." Although regional leaders, especially in the southern part of the Russian Far East, expect the Sakhalin offshore oil and gas projects to resolve endemic energy shortages in the long run, inter-regional competition within the Russian Far East has made proposed pipeline projects more difficult to implement.

Although foreign companies and Sakhalin officials often find themselves on the same side in political battles with Moscow over PSAs, in Sakhalin as in other Far Eastern regions, officials have been suspicious of foreign investors. The speaker of the Oblast Duma called for the books of foreign oil companies to be audited and the governor required his administration's oversight department, along with the Federal Security Bureau, to approve all contracts with foreign firms. Likewise, at times the oblast administration has given preferential treatment to certain local firms. Joint ventures in Sakhalin face the same dizzying array of taxes and changeable rules of the game. Local content rules have led to some bad feeling, when projects have selected foreign suppliers instead of Russian ones. The 70 percent local content goal established for Sakhalin-2 has not been achieved, for example, but more than half of the suppliers for the project are Russian companies. Most Sakhalin officials nevertheless view Russian participation in the projects positively and hope that in time local businesses will become more competitive when they bid for lucrative contracts. Although Russian investment in the oil and gas projects thus far has been minor, a Russian company, Alfa-Eko expressed interest in investing \$15 million to conduct a seismic survey in Sakhalin 6 along with Petrosakh, the Sakhalin Oblast oil company.

Foreign companies that have made a commitment to Sakhalin believe that over time the potential benefits of economic cooperation will reduce local concerns about the consequences of foreign involvement and that in the long run their operations will be profitable. According to one sub-contractor for Sakhalin-1, public opinion in Nogilki, the base for the project, became more supportive when the company assumed the cost of replacing pipes made with asbestos out of concern for public health. Although the local

population initially had been wary of foreign control and concerned about the environmental impact of a major oil and gas project, workers involved in the venture soon benefited by receiving well-constructed homes and lucrative jobs.

Putin's Political Reforms Policies: Impact on the Russian Far East

Due to its remote location, governing the Russian Far East has always been a difficult political challenge for Russian policymakers.⁵⁷ In the 1990s, regional politicians governed autonomously, staking out positions and developing policies often contradicting Moscow's policies. Bilateral treaties or separate understandings, many of which contradict the Russian Constitution, governed relations between Moscow and most of the regions. The Kremlin signed power-sharing treaties with the Republic of Sakha (June 1995), Khabarovsk Krai (May 1996), Sakhalin Region (May 1996), Magadan Region (July 1997), and Amur Region (May 1998). In the Russian Far East, only Primorskii Krai, Kamchatka Region, the Jewish Autonomous Region, Chukotka, and the Koryak Autonomous Okrug do not have power-sharing agreements with Moscow. In the case of Primorskii Krai, former Governor Evgenii Nazdratenko preferred extracting individual concessions and privileges in a continual game of high-stakes bargaining with Moscow.

Unlike Yeltsin, who handed out federal subsidies and special privileges to particular regions as a part of a "divide and rule strategy," Putin has sought to restore order in center-regional relations by appointing a military man, General Konstantin Pulikovskii, as his representative to a newly created Far East Federal district, and entrusting him to remove troublesome governors, harmonize regional legislation with federal laws, and acquire greater oversight over regional budgets. Because many of the

power-sharing treaties contradict the constitution, President Putin established a commission on June 26, 2001, to review their utility, but thus far they remain in place in the Russian Far East.

In June 2000, none of the governors welcomed the arrival of Pulikovskii to the Far East, an area known for localism and leaders with strong personalities. Not surprisingly, Pulikovskii has found Khabarovsk Governor Viktor Ishaev one of the most difficult governors to work with—Ishaev has seen the establishment of the okrug office in his home region as an attack on his own authority. However, since many regions are dependent on federal subsidies, their governors must cultivate at least viable relations with Pulikovskii. Despite his unsuccessful efforts to achieve the election of his deputy as governor of Primorskii Krai, Pulikovskii claims to get along best with the new Primorskii Krai Governor Sergei Darkin, whose region relies extensively on federal support.⁵⁸ Governor Mikhail Mashkovtsev of Kamchatka Region, also dependent on substantial federal subsidies as well as support for its submarine bases, even requested that Pulikovskii select a member of his staff to facilitate cooperation between the region's administration and the okrug office and improve the region's access to the corridors of power in Moscow.⁵⁹ Nevertheless, increased federal attention has been designed to enhance Moscow's political control, rather than to promote needed development, and has introduced a new level of federal bureaucracy, such that regional politicians and foreign investors alike must lobby the presidential representative's district office, headquartered in Khabarovsk, in addition to central ministries in Moscow.

Putin's changes in the division of tax revenues between the center and the regions have made the regions more financially dependent on Moscow and diminished their

bargaining power. Sakha, for example, lost more than half of its tax revenues to Moscow, thereby curtailing the considerable fiscal autonomy the republic had codified in its power-sharing treaty with Moscow.⁶⁰

Moreover, the Kremlin has sought to expand its leverage with additional mechanisms, including direct control over regional treasuries and the restructuring of major state-owned industries. After Darkin's election, Prime Minister Kasyanov noted that the new governor "had inherited a very burdensome legacy," but had confidence in his ability to reverse these unfavorable economic trends in the near future. Nevertheless, Kasyanov announced that the federal treasury would fund the region's treasury directly, in an effort to reduce the possibility that regional officials could use federal funds in ways that the federal government did not intend.⁶¹

Darkin has stated that he hopes to reduce Primorskii Krai's dependence on federal subsidies (now accounting for approximately one-third of the region's 19 billion rubles in revenue), but it is unclear where he will recoup the shortfall.⁶² He has lowered expectations about the prospects for attracting major foreign investment, and instead, as we will see below, appears to be courting Russian business.

In Khabarovsk, regional authorities are opposing a plan to privatize the Komsomolsk-na-Amure aviation plant manufacturing Sukhoi aircraft (KnAAPO), which bring in billions in revenues through fighter plane sales to China. On November 26, 2001 Putin signed a decree forming the Sukhoi holding company and calling for the privatization of the Komsomolsk and Novosibirsk factories. Although the Kremlin claims that the change in ownership would not deprive Khabarovsk of revenue, Ishaev has criticized the plan, which is to be implemented in 2003. Meanwhile in March 2002,

Sukhoi managed to divert a long-standing contract to supply 40 SU-30MKK fighters to China from KnAAPO in order to concentrate profits in the design bureau and use them to develop a new fifth-generation fighter.⁶³

While federal authorities have been limiting their support for the region, Russia's oligarchs are increasingly staking their claim to regional assets, and, in the case of Chukotka, where Sibneft tycoon Roman Abramovich was elected governor in December 2000, to regional political power. Abramovich has been taking steps to improve the okrug's investment climate, and his concerted efforts to court foreign investors, especially Americans, have paid off. On February 4, 2002, Sibneft signed a framework agreement with Halliburton (headed by U.S. Vice-President Dick Cheney in 1995-00) to provide oilfield services in exploration projects in Chukotka, where the company has significant on-shore and offshore interests. According to Abramovich, the federal center already over-regulates the okrug—designated a restricted zone in 1996, travel to Chukotka requires approval from the regional government as well as federal immigration authorities, a process hampering the activities of foreign investors and adventure tourists from Alaska.

Abramovich, as well as Leonid Korotkov, the new governor of Amurskaya Oblast, and Sergei Darkin, elected governor of Primorskii Krai in June 2001, represent a new younger generation of pragmatic regional political leaders, who aim to enhance their national standing by coming to terms with central government officials and major business groups. Since businessman Sergei Darkin was elected governor in Primorskii Krai, major business groups, such as MDM (Mezhregional'nyi delovoi mir), Severstal, Evrazholding, and Novolipetsk Metallurgical Holding, have been moving into the region

in an effort to acquire control over commercial seaports and reduce shipping costs to an expanding clientele in Asia. In late 2001, Severstal purchased a 60 percent stake in the Vostochnii Commercial seaport and in January 2002 Evrazholding bought 60 percent of the shares in the Nakhodka Commercial seaport, while Novolipetsk is seeking to buy into the Vladivostok Commercial seaport. However, Russia's Transport ministry is preparing legislation ensuring that the federal government will maintain control over the land, property, area of water, and technical buildings, while private companies could operate port services.

Darkin has sought federal support for Primorskii Krai's fishing interests, for a time at the mercy of his predecessor Evgenii Nazdratenko, whom Putin made head of the State Fisheries Committee in February 2001 in exchange for "voluntarily" resigning as governor, after repeated efforts by Moscow to remove him from office. After Darkin complained to Kasyanov about Nazdratenko's mismanagement of fishing quotas, Nazdratenko was suspended from his post for one month.⁶⁴ In May 2003, Nazdratenko once again was kicked upstairs, this time to the National Security Council, where he will head the Department of Ecology and Bioresources.

For the Kremlin, control over the revenue and assets of Alrosa, the Sakha diamond monopoly, is a key issue. After the Russian Constitutional Court ruled in June 2000 that the federal government owns Russia's natural resources, the Kremlin has been seeking to regain control over the revenue from Sakha's diamond mines. Sakha receives 70 percent of its revenue from diamonds.

In June 2001, federal auditors investigated the history of the Alrosa's incorporation and Sakha's majority ownership. The Sakha and federal authorities

currently each own 32 percent of Alrosa shares, while 23 percent belongs to the workers, 8 percent to eight Sakha district governments, and 5 percent to a federal veterans' organization. Thus, Sakha effectively controls 63 percent of the shares, the 32 percent republican stake, plus the 23 percent belonging to the workers, and the 8 percent controlled by districts in Sakha. After Putin asked Prime Minister Mikhail Kasyanov to take steps to protect state property in the diamond industry, the Property Ministry began investigating ways to increase the federal stake in Alrosa to 51 percent. To forestall any reappropriation of Sakha shares, Nikolaev decided to transfer the republic's 32 percent stake to Sakhinvest, a private fund. The federal government also is trying to redirect the money Alrosa pays in rent to Sakha for its mines. Although the Kremlin succeeded in securing the election of a new president of both the Sakha republic and of Alrosa, it remains far from clear whether Moscow will succeed in increasing its influence over the republic's lucrative diamond industry.

Conclusion

Increasing interest by Asian states in diversifying energy supplies and finding less costly East-West shipping routes have focused attention on potential opportunities in the Russian Far East. Yet underdevelopment, political instability, and crime undermine efforts by political leaders in Moscow and the Russian Far East to integrate the region more fully into the Asian economy. Complicating the picture further, in the absence of sufficient federal economic support or foreign investment, Russian oligarchs increasingly are moving into the region to advance their own economic and political agendas and are competing for their share of the rich resources of the Russian Far East.

Over the past decade, the region has made notable progress in expanding its trade partners and attracting substantial foreign investment, especially in the Sakhalin offshore oil and gas projects. Nevertheless, for Putin, support for the economic development of the Russian Far East runs second to his aim of regaining effective political control over fractious but resource-rich regions. Forestalling political disintegration is not a solution to the region's integration in Asia, however. Until the more fundamental issues of regional economic and political development are addressed, the Russian Far East is unlikely to play more than a marginal role in the Pacific Rim.

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