

# 1. General introduction

Focus throughout this text will be on the development in the group of five North East Asian (NEA) countries, Russia, Japan, China, South Korea and North Korea<sup>1</sup>. The time frame covered will mostly be the years since the late 1990s and with a focus on the development in the years 2003 – 2004. A time period that will initially be used to exemplify a large number of geographic and economic processes that take place in countries generally. It is here shown and explained in a NEA setting. In the background, to all that is being covered, are processes related to the so-called economic “*globalization*”, along with the Achilles’ heels of this process, trade, energy, and transport.

## 1.1. A changing world economy

As a result of the increasingly global setting of the world economy, with its increased interdependence in-between countries, it is becoming ever more difficult, if not impossible, to really control the economic development for politicians and multilateral organizations. This could, depending upon one’s personal point of departure, be looked upon as a positive, but also a negative effect. The increased mobility of money is just one such example. This has led to that short-term speculation, in assets, but more dramatically, in the valuation of currencies, that leads to devastating effects on the economies of entire nations. This was demonstrated on a global scale with the breakout of the so-called “*Asian Crises*” in 1997. With capital owners having the upper hand in the process, it has become increasingly difficult, not only for companies but also for nations, to try to pursue a development agenda that is anything else than mainstream. On the domestic scene, it is still vote-seeking politicians that set the agenda, often with a preference of a status quo (best is no or only limited change), but the international reaction to the adopted policies is often best reflected by movements in currency values and changes in Foreign Direct Investment (FDI) flows.

The quick pace of economic growth that has been seen during the current millennium among Asian economies and the quick recovery from the 1997 crises has surprised many. A crisis that had its origin financially in Thailand, widened to Indonesia and then came to expose fundamental structural problems in all of the regions, economies. Increased international competition has since further strengthened demands for efficiency and productivity among countries and between companies. But the process has also increased demands on governments to show transparency in their operations and accountability for costs incurred.

Economic institutions, inside nations as well as outside, are spatially entangled in stable as well as shifting webs of socialized and institutionalized relationships. As such, these economic institutions cannot be looked upon as economic machines that respond to external market and cost conditions as perfect representatives and defenders of the market economic system. It is also important to remember that they should be looked upon as organizations made up of social relations among individual actors, where actions are both being facilitated and hindered by the structure of the institution and the resources available. The context in which a company, organization or country, is acting is important for the understanding as it is, also and always, an integral part of the subject or object under investigation.

There is an invisible constant process at work that attempts to balance the influence between attempts to regionalize production systems and to globalize production. Each country and each region aim at retaining as much as possible the production chains, of manufactures as well as of the production of services. This is done against the will of, alternatively in co-operation with, first of all Trans National Companies (TNCs). A process that can include state subsidies as a carrot, and binding laws as sticks, to make TNCs follow what is locally or nationally, are seen as the most favorable way of action. Activities still have to be conducted inside the framework of what is ruled as being allowed by multilateral organizations, like the World Trade Organization (WTO) and the EU. Politicians and business leaders constantly face new challenges in these fields. EU enlargement in Europe and the global pressure on production costs from increasingly skilled labor in all parts of East Asia forces responsible governments in the west to rethink local employment policies. How will multinational groupings, individual nations, natural region at large and sub regions in particular, sustain competitiveness, growth and employment in an age of outsourcing?<sup>22</sup> Employers, labor unions, researchers and politicians will be forced to reevaluate how to adjust general framework conditions for growth and prosperity, including the labor market (where applicable). In many countries, state employment regulations and labor market organizations need to adjust to new challenges from a multitude of aspects.

Workers rights, referring to issues such as pay, protection, right to organize a s o, has with increased global competition become an ever more disputed issue. What are basic rights in a highly developed country is often far from the case in third world countries. To accept a workplace that includes clearly hazardous conditions, or is low paid with long working hours, could be the only work available for some low skilled worker in a less developed country. This neglect of environmental concerns and basic workers right gives an unfair competitive advantage to this substandard employer, compared to employers in developed countries that much follow strict regulations in these respects. Also the right of

organization, which is another basic workers right, is still not allowed in many countries. On the other hand the existence of multiple worker unions at the same work place, as is the case in many developed countries, can be as destructive as it often leads to “*hold-up*” problems and slows the decision-making.

As internationalization gains momentum it not only becomes increasingly difficult to establish the ownership of assets, but also to establish responsibility. Or does it really matter who owns things? In a more globalised economy the distinction between “*who is us*” and “*who are they*” becomes increasingly blurred. If the state should give active support to improve domestic growth, or work place generation capacity, what and who should be favored? Should it be domestic outbound investments or international inbound investments, should domestic owners be favored ahead of foreign owners? Among the countries covered here, two typical such examples can be given that well show the blurredness that has emerged from the internationalization of capital flows. A lot of the capital that is moving around between Asian nations, and to an increasing extent concentrating on China, is controlled by Chinese nationals living in, or in the near surroundings of, China, frequently “*lending*” capital inside the extended family circle. Should this be considered to be foreign capital? In the case of Russia a similar pattern can be observed when in later years FDIs have started to flow into Russia from offshore tax heavens<sup>3</sup>. Overwhelmingly this is capital that has been “*washed*” and that is now returning in the form of FDIs. Should this be considered to be foreign capital?

The purpose of eventual FDIs in the different cases cannot be overlooked, if it is aimed for establishing manufacturing export, or if the production is destined for consumption on the local market. However, any FDI will still be generating new workplaces and it will generate an inflow of foreign capital, at least in the short run. Most developing and expanding economies are very dependent on inward capital flow in the form of FDIs, which is needed to balance out a current-account deficit. Without such an inflow there would be a need to raise the national foreign debt, which would mean costly interest payments. It is uncertain how long such a process can continue and, as so often, it remains dependent upon a number of other economic parameters. From the point of view of stability of the macro-economic development, this dependence also forms a medium-term risk for foreign investors operating in an economy.

The long-term determinant of the flow of FDIs is the incentive structure, allowing investors to make a profit, in the short or the long turn. Another much discussed factor is that of innovation capacity. It is not necessary investments that are made with the aim of finding the most innovative environment is not necessary, the reason could well be just low production costs, and if that is the

case then R & D will be conducted elsewhere inside, or perhaps outside, the company. As changes occur, e.g. in the investment and innovation climates, being the result of on-going processes, it is not very easy to quantify changes. The diversity of activities in the business society could also produce results that are positive for one kind of activity, but also be negative for another. On the other hand, for a less developed country practically any kind of FDI can be said to improve the local business and innovation climate, including the national currency balance. The intention here is not to explain the diversity of aspects around FDIs, but just briefly show its diversity. As the initial setting in different countries and regions can be expected to be very different, it is not really possible to write a brief general description of the effects of FDIs. In later parts containing the descriptions of the different countries, this subject will be touched upon again, several times, when investments flows will be discussed.

## **1.2. NEA in the world economy**

This NEA group of countries is becoming increasingly important in the world economy, with Japan already being the second most important economy in the world with China and Russia being subject to rapid economic growth. It is not only from an economic point of view that this group of countries are important, generating just under of 20% of the worlds Gross Domestic Products (GDP) in 2003 (UN-Stat, 2004-08-18). These five countries also include about 18% of the world's landmass and 26% of its population; 28 million km<sup>2</sup> out of 148 million km<sup>2</sup>, and 1.66 bn out of 6.3 bn, respectively (UN-PP, 2004-06-01)<sup>4</sup>. A more comprehensible perspective is probably to show the NEA countries relative to some selected economies in the world (see Table 1.1.). As shown in Table 1.1 the NEA economies covered, compare well in importance, also individually, with other countries generally considered to be important in the world economy.

The world economy is expected to grow by about 4.8% during 2004, which will be the highest in something like a generation (IIE, 2004-03-30). Growth in the US is expected to reach 4.5% for 2004 and 3.5% in the following year. At the same time, the Asian economies are forecasted to grow 7.5% during 2004 and 6.25% in 2005 (IMF, 2004-04-01). Grey clouds for such prognoses are oil prices, which are expected to decline only moderately over the next two years, but also that the US Federal Reserve will raise interest rate from its record low of around 1%. Additionally, during the course of 2004, the declining value of the USD, indirectly leads to increasing valuations for the Korean Won and the Japanese Yen. It is therefore worrying that the US, as the world's most important economy and the world's most important importer of goods, has maintained its position by building on a national deficit that has reached around USD 420 bn

for 2004, well surpassing the record since WW II, USD 375, for 2003 (CBPP, 2004-10-01). These figures are both small compared to the total national debt, that by the end of September 2004 had reached USD 7.4 trillions (USD 25 000/ capita) (public debt, 2004-10-05). Continuous rise of the US deficits will, in the long run, lift global interest rates, to make lenders better willing to take the risk of financing such a deficit, at the same time, as the value of the US dollar would need to decrease to help offset the US current-account deficit<sup>5</sup>. The US economic recovery during 2003 – 2004 has proven different from previous economic recoveries, as it has been supported by the fastest productivity growth since World War II. As a result, the employment growth has been slower than previously in relation to the improvement of the economy. Despite constant economic growth, about 2.3 million jobs have been lost in the US only over the last three years (Council of Economic Advisors, 2004-04-01). Imports from NEA have been given the blame for much of the jobs lost, as the US runs a deficit in its international trade that for the first seven months of 2004 had reached USD 351 bn (US CB, 2004-09-10). Also the EU region has seen job losses and has faced constant unemployment levels, from 6% to over 15% in all of its 25-member countries, with an average of 10% for EU in August 2004. Over the next few years, despite productivity gains, it is still hoped that the positive economic development should lead to an increase in both jobs and wages (EUROSTAT, 2004-09-29).

**Table 1.1. NEA Countries Economies Compared to other countries**

GDP– Gross Domestic Product; PPP– Purchasing Power Parity, HDI– Human Development Index,

GDP	2002	2003	2004	GDP/cap	PPP Value	PPP Rank	HDI Rank	Export %
China(1)	1 270	1 420	1 650	1 100	5 900	119	94	22
Russia	350	430	410	3 000	8 900	82	57	43
Japan	4 000	4 300	4 300	33 600	28 500	19	9	10
Korea	550	610	660	12 600	18 000	47	28	39
Brazil	460	490	510	2 800	7 500	86	72	10
India	510	600	650	550	2 900	146	127	12
UK	1 600	1 800	1 950	30 500	27 700	21	12	26
US	10 400	10 900	11 300	37 600	37 800	4	8	11

Export % - Export in Goods and Services in Relation to GDP.

(1)= In GDP/Capita and PPP/Capita Hong Kong China is 16 and 17 in 2003 world ranking; over 100 ahead of China.

Sources: GDP for 2002 – 2003 and PPP 2003 ([www.worldbank.org](http://www.worldbank.org));

GDP 2004 from later chapters(i.e. national statistical offices); HDI 2003 values ([www.undp.org](http://www.undp.org)); Export % ([www.worldbank.org](http://www.worldbank.org)).

Many of the less developed economies in the world have shown high growth figures during later years, and in some cases for over a decade, much due to the low initial level. With a GDP growth of about 7% per year and a 2% growth in developed countries, it could still take as much as a quarter of a century to catch-up with even the middle-income level countries in the West. The slow process of change in this respect will leave the US and Japan, for a long time to come, as the unrivalled most important economies of the world, and probably also as the most important sources of FDI.

With the increase that has been seen in the cooperation inside the Association of South East Asian Nations (ASEAN) organization, and perhaps even more so inside ASEAN + 3, Asian regionalization could gather further force. Over time, such a regional organization could eventually challenge the regional cooperation between the EU countries and the North Atlantic Free Trade Area – NAFTA (which includes the US, Canada and Mexico)<sup>6</sup>. If such an Asian organization could be formed, the world's three most important groupings would have much to gain from cooperation in a “*trilateral axis*”. This because such a “*triad-of-regions*” would dominate the world economy and, when finding common positions, similarly so in all international organizations.

During the Asian crises of 1997 – 98, there were practically no countries in Asia that, from time to time, did not have to face adjustments in the value of its currency in relation to other currencies. Changes generally depend on how the national economy develops, or is expected to develop. An increase in value, i.e., purchasing power, for the local currency will inevitably make foreign products cheaper for domestic consumers, increasing imports, as more can be bought for one unit of the local currency. An increase in the value of the domestic currency in relation to others, which is more rapid than the lowering of costs, must, normally, compensate with an increase in domestic productivity, or, eventually, a lowering of profits by the producers. That is if the same price relation for local products versus foreign competitors is to be maintained. The importance of currency movements will also affect different lines of business, depend ending on how large share of incomes and costs that are related to different currencies. The worst scenario is a company having a large share of its incomes in a falling currency and costs in a rising one, which makes the showing of a healthy profit in the domestic currency very difficult. For a company that both source and sell in the domestic currency, fluctuations in foreign currency values are often less important.

A common Asian currency, mentioned at times in the region, e.g., to be used by some countries in the ASEAN +3 group, could be in the making as a way to gain increased economic stability. The emergence of a currency unit in Asia would

not necessarily have to take long, and be a complicated process, as the establishing of the EURO currency in Europe. Much can probably be learnt from that process, making the establishment of an eventual “Asean” currency a somewhat easier process to handle.

Initiating major processes, like the possible introduction of an “Asean” currency, but also something smaller and less controversial will always face both support and opposition. There is no such thing as a clean sheet for anyone – geography, as well as history, will always matter!! Smaller countries that are positioned lower on the ladder of development will probably always have a bigger window of opportunity in times of change than bigger and more established countries. This is much due to the fact that existing and well-established economic institutions are more resistant and slower to change. It cannot be taken for granted that the gains from new measures, or investments, will even be visible where the costs are being carried; often making such investments hard to motivate. Investments in environmental issues are the perfect example of this.

Environmental issues have been given very limited space in this introduction as in the following descriptions. In the near future it is probably so that no question can be addressed without paying attention to environmental concerns. To convert and maintain production processes in a way that can be sustainable for the future is becoming an increasingly pressing global issue. If countries do not take environmental issues seriously, although it could obstruct local economic development in the short run, the money and personal outlays that will be needed to overcome problems later will be many times higher. To establish responsibility, due to blurred and long distant ownership to companies, could come especially alarming from an environmental point of view, as the cost for cleaning up eventual damages, i.e., correct mistakes, could rise to near astronomic levels in this field.

Another important question that has been given a somewhat wider coverage, but still being far from touching upon all interesting questions related to the national economic development. Most questions can only be touch upon and only briefly be mentioned, but discussions in greater detail must be looked for elsewhere. Examples of such issues could be detailed descriptions of economic policy, banking, the financial sector, taxation, social relations, investment climate, retailing, legal framework, multilateral relations, domestic politics and so on.

Under current circumstances, in which private and public organizations are set to work, it has become increasingly important to stay updated and well informed about the development in once business environment. With an ever

more turbulent environment surrounding different types of operations, the risk of over reacting on recent information also increases considerably. Information has become increasingly valuable and respected as an asset in its own right, but the problem to make use of it. However, the “winner” will always be the person or organization who have the best judgment. In an increasing flow of information, the problem is to distinguish between what is just a short-term adjustment and when the same indicators instead show the beginning of a new long-term trend. If prognoses are built strictly on the latest information, they will practically always indicate that much larger changes are at hand than what is really about to happen.

As in any other economic process, the winners and losers from globalization, e.g. FDIs, are never the same. At the same time, the gains will seldom happen geographically anywhere near where the losses occur. Occasionally, several of the negative effects will come to affect the same country, or even region/town. Often resulting in unexpected unemployment for many.

### **1.3. Manufacturing**

In most countries, focus is often being placed on rapid economic development as a way to increase national wealth. This is something that can be achieved in a number of ways, but in later years, and especially when concerning less-developed countries, much focus has been put on the ability to attract FDI. Investments, if discussing manufacturing companies, are often related to later stages in the development process when companies are expanding or restructuring. A much-simplified explanation to this process, when it comes to production, could be the following. Initially, a product as well as service, of which there is little or no domestic production, will be imported. In the next stage, when local production has been established, it is mostly aimed at import substitution and at expanding the local market. When efficiency has increased, it is followed by export of the product. When the scale of this export has reached a sufficient volume, it could be time to establish new production units in one or several of the larger export markets. It is today increasingly likely that the production is being restructured inside the company, with the aim of specializing the production at different units, as a way of increasing internal efficiency. This kind of regional specialization leads to the establishment of regional centers, but also increased trade. The increasing trade comes from the fact that more products now must be transported in-between the different production units and to more distant customers. Less than a generation ago, this process of transformation of industry included a dimension of letting older models of products being produced in less demanding market with a lower



purchasing power. This kind of company behavior has become increasingly difficult to pursue today. In an information society, differences of this type, between countries and between companies are getting increasingly unsustainable. All over the world, consumers today have the possibility to read the latest product releases on all major manufacturers home pages and to follow the results from tests done of these products by the leading magazines in the concerned line of business. Irrespective of if the company is based in Japan, the potential consumer lives in Cambodia and the magazine is being published in New York. A dissemination process of information that would probably had taken years not many years ago.

Generally, it is easier for smaller countries to internationalize, like for small states in Europe and near city-states like Singapore. In the same states where the spread of Information and Communication Technology (ICT) has been both rapid and wide, further increasing the technological gap to underdeveloped countries. With increased usage of ICT, these are states that have been able to relocate labor-intensive parts of their production abroad (or simply lost it) and instead specialized in higher value-add products, R&D, design, finance, insurance and legal support. This development has allowed an increased functional integration among industrial companies units that are geographically dispersed. It should be observed that much of the future focus will be placed on the delivery of services. Manufacturing is often the activity in society that is frequently focused upon in economic discussions; as well as here. This is an unfairly large degree of attention as there are practically no countries where manufacturing employs half the workforce or contributes to half the GDP. The contribution from manufacturing is normally in the range around 30% of both employment and GDP contribution in most developed countries. Instead it is actually the service sector that is generating the largest economic contribution and generally also in employment terms. If discussing a less developed country, it is instead often farming that is the biggest generator of employment, but that rarely is the largest economic contributor.

Developed states in North America and Europe have long comforted themselves with the reassurance that manufacture might be moving to low wage locations, but in the new era of service and software's the main skills and systems would stay in the serve-rich developed markets. This has particularly been said to apply to high-level financial services where cities like London and New York still appear to command the global scene. The sector in focus has instead been manufactured of goods in developed countries that are generally in the process of searching for ways to lower costs. In just the last few years, this search for low cost has also come to affect routine and labor intensive service-related functions. Relocation abroad can reduce cost significantly, but would have been impossible

without dramatic advances inside the ICT sector. Not only for service functions like customer support has this practice started to occur, but also for more advanced services like computer programming. With wages often at a level of 20%, or less, compared to the developed countries, any kind of job could be at risk (MercerHR, 2004-10-12). However, it is seldom so that one single factor can be said to explain this kind of trend, as there are also a desire among firms to improve business conditions and expand markets. Relatively few firms in developed countries, however, are moving out the R&D activities of their parent company; thus far. On the other hand, to achieve their aims of cost reduction, firms often face different new problems in less developed countries. They have to put up with the handicap of the deficient infrastructure and public administration; for which costs are difficult to assess and are therefore, perhaps, too readily accepted.

The often-simplified answer to increased efficiency is to strive for a higher degree of specialization. One company can often become more efficient this way, but such a step also increases the demand for coordination between companies as the level of outsourcing in a highly specialized system also increases. Actors, the activities they perform and the resources used in their processes, physical as well as in the form of services, have increasingly started to be re-evaluated. However, this is a process of change where the focus could be set very differently dependent upon the point of departure. Only a very brief mentioning will be made here of the effect of these shifts have, and will have, in different sectors. Direct effects will be seen inside e.g. manufacturing, infrastructure, transport, but here as elsewhere there are also structures restricting this process of change. As product's life cycles in the twenty-first century has become ever shorter, which in turn and in an increasingly number of ways, it has also generated pressure on constant adaptations in-between business partners. Increased coordination between a supplier's manufacturing department and a customer's production process or sales department (if the products are sold for consumption) will normally increase efficiency in the total production system. But, not to be forgotten, this coordination will also result in increased indirect costs for all parties. The latter kind of cost is probably more difficult to directly quantify and, as a result of this, is often overlooked and probably underestimated. From this follows, near unavoidably, an increased focus in such a system on finding ways to make an optimal use of the resources available. This is in line with the common saying "*the less the better*". This leads to a drive inside organizations towards a maximum reduction of storage levels, standardization of procedures and a desire to make the organization work as "*lean*" as possible. The value of a resource in a wider meaning is often given by the circumstances, but can probably never be seen as stable and will depend on in what way it is being combined with other types of resources. It logically follows that to

minimize the use of resources is not always the most important issue. Instead, it is the continuous search for new ideas and to find better ways to combine available resources of different kinds that should come into focus. In a time when the lifecycles for products becomes ever shorter, the economic rewards for the most innovative ideas in this field will increase further.

Changes to production patterns and the geographical locations of actors in current day production networks will see much of the twentieth century discussions as production chains become increasingly old-fashioned. This is the result of the increasing interdependence that is characterizing manufacturing networks of the twenty-first century, and the global location of customers for the products. When a company increases its dependence on outside sources to enhance efficiency and capacity, its in-house capability to create value-add will fall. The producer will now increasingly come to depend on the capacity of other companies to both adapt and to innovate. Especially so as increasingly shorter product life cycles and increasing returns are available for the manufacturer that, at a short notice, it can respond to sudden changes in demand. That is if demand from customers for the product in question surpasses or, eventually, falls below plans and expectations.

Despite the changes that have taken place inside production systems, especially larger global companies are still bound to have their base in a country that will give both owners and investors enough security to make the companies attractive. Consequently, there will also be attempts from different countries, in competition with each other, trying to attract these head offices, and indirectly attempting to obtain a larger share of the values being generated by these emerging global production networks. As these networks form in increasing numbers, they are also reshaping industrial production, and it is not only in the Asian region where this competition affects and creates competitiveness. The forming of these networks, under the label of globalization or regionalization, and their development, is rarely state projects, but spontaneous inside the line of business. There are more or less two different ways to put the emphasis when studying the diffusion of ideas and work methods needed for successfully establishing a well-working region. The geographical proximity of firms or the organizational proximity, where the latter instead see something like a shared identity or a common understanding, is more important than physical proximity.

In later years internationalization has included many more aspects than just production and currently includes sourcing of various inputs, product development, marketing, and a struggle for global market shares. The creation of new industrial clusters and regional clusters, with firms in geographical

proximity and often with strong state support, has not been unproblematic<sup>7</sup>. New clusters both need to attract the necessary supporting lines of business at the same time as cooperation and competition between firms are seen as important for the long-term survival of all participants. To become attractive and to achieve self-supportive growth, they must also reach a certain critical mass/size. The more or less unforeseeable speed by which the globalization process has proceeded during the last ten years, its pure scale, its increasing complexity and the ways it has come to include both finance and the transfer of technology, has often made existing national, as well as international, regulator systems outdated. This has forced into place changes in a multitude of aspects, especially in the developed world.

The facilitation of long distance information exchange, has also allowed instant feedback about all aspects of globalization. Internationalization has been far from only positive, undoubtedly, it has also come to generate a number of negative aspects. NGOs, labor organizations along with a broad spectrum of social groups in developed countries have come to backlash against these side effects. In the hunt for someone that can be called responsible in this dispersed and faceless process it has often become "*global capitalism*" and international organizations like the WTO and IMF has been blamed. Arguments for and against only the work of the IMF would fill at least a few books, which highlight the complexity of the process. What from one point of view is negative could often be proven to be very positive from another point of view. Analyzing and discussing only smaller parts of the occurring changes is often intended to make the changes more comprehensible. But the heart and soul of the process of globalization is that it is global, and from its nature follows that it is an extremely interrelated and complex issue. A process that is, regrettably, becoming increasingly difficult to simplify in a structured way, although this text is also such an attempt.

#### **1.4. Trade**

Free and open trade between countries still enjoys the highest moral ground. It remains to be proven that other ways exist to reach higher long-term human standards of living. International trade has seen an unprecedented increase over the last fifty years with an average growth of about 6% per year over that time period. Total world trade in 2003 had reached about twenty tree times compared to the level in 1950, with merchandise trade in 2003 being valued at USD 7.3 trillion and with trade in commercial services valued at USD 1.5 trillion. That protectionism in the current century generates little job growth, which is probably easy to find common census for. In times of weak global economic

development though, the arguments for free trade are often indirectly being undermined. However, studies have shown that to cut about 1/3 of today's trade barriers could boost the world economy by up to USD 500 billions (WTO, 2004-05-10).

Up until the 1980s the world had, for nearly thirty years, remained a market with relatively free flow of goods, although the really big take-off in volume was yet to come. At the time the US had long dominated, but at the same time it looked like Japan would continue to expand, both as an export-based producer and to become an increasingly important market. Dramatic changes were to come, however, and in just a few year's time, the emerging Japanese wonder had stalled and later, it was instead the rising star of China as a producer, and gradually also as a market, that emerged. There used to be a sort of superior view that the West, and perhaps US and Europe in particular, would do all the thinking, innovating and designing, while Eastern Asia and later Eastern Europe, with its cheap labor, would turn out the more basic items. In due course, the cheap labor would become more skilled and earn more; rising costs among *second generation producers* which would give room for new poorer countries to take over the low cost production. In the long run, incomes would rise for practically all and everything would be more or less evened out rather smoothly in the world trade balance. The most widely recognized positive examples during this period, and that has greatly profited from the free trade, have been the group of so called "*Asian Tigers*"<sup>8</sup>. The only problem is that this has never been near to happen for more than a handful of countries, and the income disparity between rich and poor countries has continued to increase. Still, by 2004 almost 50% of the children in the world continue to live in poverty, which leaves much to be desired when it comes to income distribution (UNICEF, 2004-12-07). That is albeit the fact that the number of "*very poor*" in the world, i.e., earning less than USD 1/ day, seems to have stabilized around 250 million, and much so due to improvements in China (WB, 2004-10-15).

That production pattern for most manufactured products has changed dramatically over the last ten to twenty years was briefly mentioned above. Previous local production networks have often fallen short in competition with large-scale global networks with the same production focus. This has lead to a growing sense of threat from low cost production among population strata's in established developed countries, when seeing cheap components, as well as products that are being sourced from far away locations. Especially so when also white-collar workplaces, that used to be secure, has started to move out to low cost countries. As long as job creation will not pick up dramatically in the developed world, it will probably become increasingly difficult to politically defend the high moral values of free trade. What makes economic sense globally

and what seems to make sense in local politics can well emerge as two completely opposing ideas, which still, and somehow, must function together. The old and cozy image of trade being a two-way beneficial flow of goods between far away countries could, if not nursed with great care, be fading away.

The first man who was honored to have come up with a theory concerning the advantage for nations to conduct international trade, instead of attempts to produce most kinds of goods locally, was the Englishman Adam Smith, around 1780. The simple theory was that households should never attempt to do at home what would cost the household more to produce than to buy. If both countries made use of their, what Smith called “*natural advantages*” (that one country nature-given had over another country) it would give both countries more products to consume if they specialized into a production that is based on their mutual advantage. About a century later David Ricardo was able to show in figures that two countries that held the less obvious, so called *comparative advantage* in relation to the other would also gain a considerable advantage from specialization<sup>9</sup>. Theories around the advantages of international trade and the positive effects from specialization have since been much developed, by the likes of Hecher and Ohlin in the 1930s. Over the last thirty to forty years the increasing influence of TNCs, and other aspects around globalization, has much changed the fundamentals that applied for trade in the years when basic trade theories were developed by Smith and Ricardo.

One of the major changes in world trade over the last few decades have been the rise in importance of the TNCs when it comes to international trade. This rise in importance has been much enabled and facilitated by the phenomenal improvements that the world has seen in ICT technology. At the turn of the last century about 30% of world trade is conducted inside companies<sup>10</sup>. At the same time, about 40% of FDI is being conducted inside of TNCs, with the second biggest component of world FDI being TNCs that conduct mergers and acquisitions (UNCTAD – WDR, 2004-09-16). Also, the sources of the world's FDI has changed considerably, compared with WW II, where some 45% of the total was of British origin. Some years after the war the UK share had shrunk to about 35%, with about the same volume coming from the US. In the early years of this century, the US is the leading origin, with the UK as a distanced second. It has been estimated that there are over 60 000 transnational companies, controlling over 800 000 branches. Twenty-five out of the fifty largest international companies are based in the US, with near 90% of the total being headquartered in the US, Europe or Japan (UNCTAD, 2004-09-01). In 2004, the total flow of global FDI increased by 6%, to about USD 612 bn, which was the first increase in three years. The share directed towards developing economies increased to 42%, from just 27% three years earlier, with the Asia Pacific region growing by 55%.

The US reclaimed the title from China as the most favored nation receiving USD 120 bn, up four times over 2003, compared to investment of 62 bn directed towards China (UNCTAD, 2005-01-19).

A company investing abroad is most often facing an entry into a more insecure territory than its home market. As in any type of business undertakings, there is a commercial risk that something could go wrong, and so also abroad. When making an investment abroad, there is an additional risk of political changes that had not been foreseen, or perhaps could not be foreseen, at the time. This could be the introduction of new legislation that changes the working conditions for the new establishment. These kinds of risks that companies face in different countries are constantly being followed up on by a number of international companies. In the NEA group especially Russia has been moving up in such rankings, as the domestic market has been opening up and the working of the banking system has improved (see Table 1.2).

**Table 1.2. Country Risk and Credit Rating Rankings in 2003 – 2005**

	Euromoney - Country Risk					Institutional Investor - Credit Rating				
	2005		2004		2003	2005		2004		2003
	Mars	Sept.	March	Sept.	March	March	Sept.	March	Sept.	March
China	51	50	45	49	56	37	38	38	42	38
Japan	13	14	15	17	19	19	22	21	23	20
Russia	61	64	66	72	76	58	58	59	62	64
Korea	37	37	37	38	38	28	29	29	28	27
Brazil	68	71	78	75	79	67	73	68	76	73
India	60	60	59	60	61	57	59	58	59	57
Hong Kong	26	26	25	25	26	26	26	26	29	26
Taiwan	24	25	26	26	27	24	25	25	24	24
UK	7	7	6	6	9	5	5	3	5	5
US	4	4	4	4	3	6	3	4	4	3

NB: The Euromoney **Country Risk** is a weighted average of nine categories, with political risk constituting 25% and economic performance 25% of the base, as the two most important indicators. The Institutional Investor **Credit Rating** is a weighted average based on a ranking of overall creditworthiness, but also the macro economic picture and the working of the banking system.

Source: Euromoney and Institutional Investor, through EBSCO Publishing (EBSCO, 2005-03-03)

To regulate and possibly reduce pressure from the outside world, many have seen regionalization as a possible answer. The idea to “*regionalize*” has appeared in a variety of different definitions. It has been packaged with different content,

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and has been set to cover smaller as well as larger *regions*. Depending on the reasons behind the idea to regionalize, the structuring of a region could be looked upon as “*activity based*”. If so, it would then be based upon the idea that the region concerned could in some respect be, or become, largely self-sufficient. When defining regional growth-areas, these could be both small, but also larger and made to include areas in more than one country. Also, these regions are thought to be self-sufficient; in a sense that most of the prerequisites that are seen as necessary for enhanced growth, above that of other regions, generally or just in one sector, can be found inside this special region. Another alternative is the “*market driven*” region in the form of global-, regional- or corporate production or marketing networks. In its more formalized form, regionalism could instead be, or become, “*ruled-based*” in the form of bilateral agreements in different suitable fields. When state driven, such initiatives conventionally have the intention to deepen co-operation in a near, or distant, future, like the case of the EU, ASEAN and APEC<sup>11</sup>. The creation of such regional trade organizations, on an international basis, involves a number of steps that are usually taken in the process of integration (see Table 1.3). Starting from the least committing form of arrangement being a Preferential Trade Area, reaching complete integration at the stage that here is being referred to as a Political Union. What in greater detail is agreed at different stages, and the speed with which the process proceeds, vary greatly depending upon the setting in which the regional integration is happening. Here though, we will concentrate on a discussion around international regionalism, where free-trade ideas are included as a basic idea of the organization.

**Table 1.3. Steps in Trade Integration**

	PT A	FT A	C U	C M	E U	P U
Reduced trade tariffs for selected items	X	X	X	X	X	X
Removal of trade tariffs between members		X	X	X	X	X
Common external barriers against non members			X	X	X	X
Free factor movement (e.g., labor, capital, goods)				X	X	X
Common economic policies (e.g., monetary, fiscal)					X	X
Political unification between members						X

PTA - Preferential Trade Area

FTA – Free Trade Area

CU - Custom Union

CM - Common Market

EU - Economic Union

PU - Political Union

Source: Author



#### **1.4.1. WTO and (free) trade agreements**

The General Agreement of Tariffs and Trade (GATT), that was to be restructured into the WTO in 1995, had its early focus on cutting trade tariffs on industrial products, but with its groundbreaking “*most favored nation*” clause as one of its fundamental innovations (WTO 2004-07-15)<sup>12</sup>. During increasingly difficult negotiation rounds held from the late 1950’s until the forming of WTO, issues brought up came to an ever larger extent to include other trade related questions, like the phasing out nontariff barriers in industrial goods<sup>13</sup>. Two sectors were long not considered when dealing with international trade issues; these were textiles and agriculture. The Multi-Fiber Arrangement (MFA), covering fibers, cloth, and apparels, was set up in 1974 and regulated, in great detail the field of textiles and its trade. With the negotiations of the membership of China, being the world’s leading textile producer, changes in the MFA became necessary<sup>14</sup>. It was eventually decided to phase out the MFA agreement by the end of 2004; after a full ten-year graze period. However, in the case of agriculture it is only during the last few years that a discussion about the eventual liberalizing of trade has been initiated. How problematic this field is has been demonstrated not only in the accelerated growth of import quotas for farm produce, but also in increased trade friction in this sector between less-developed countries and the richest countries of the world. During the ongoing round of WTO negotiations, the Doha round, agricultural products have been paid more attention than in any of the previous negotiation, but the sector remains a “*mine-field*” for the negotiators. It can only be hoped that the preliminary agreement to reduce both export subsidies and other forms of export support will be scaled down along with considerable cuts in direct subsidies<sup>15</sup>.

For developing countries, the membership of the WTO has become a way to gain a general international recognition for their efforts to establish a working market economic system. At the same time, membership gives trade advantages by applying the same set of regulations as among other members, which greatly facilitates trade and access to foreign markets. Membership also provides nondiscriminatory treatment against exported products, and in cases where disputes could arise it makes it possible to solve the conflict at the international dispute settlement mechanism under WTO<sup>16</sup>.

However, negotiations for new members include a more or less complete revision of all trade related aspects of the applicant’s legal system, which could have an influence on the internal market and international trade. As a result of this process, the regulations that are seen as acceptable for entry by other members indirectly streamlines countries. New members will be allowed in,

only if they accept all existing paragraphs in the membership charter, possibly having won a maximum ten-year grace period to adapt to the most difficult ones. Having gone through this, and final dates having been set for possible changes needed, the country in question not only becomes more likely to be seen as a trustworthy trade partner, but also as an attractive destination for FDIs. It is not only international investors that will reap the profits from the changes. It is generally anticipated that the opening up of the local market will also improve the domestic business climate. This is to be achieved through a combination of quality and quantity improvements in domestic production. This is expected to follow as a result of enhanced competition from increased exposure to foreign products. WTO negotiations have, over the last decade, not only been made to include the wider trade-related fields of services, and investments, but also to open up markets for international investors. The benefits to less-developed countries when entering the WTO most often lies in the standardization and expansion of the export market, more preferential treatment in trade and the boost to the development of national enterprises that increased competition will give<sup>17</sup>. Meanwhile, one of the major, although indirect, costs for a country is the reduced influence that the government will have in forming economic policies. A membership reduces the possibilities to support economic development, regionally or in different sectors, as that can/will distort the free competition. The results from members that have recently joined the WTO have indeed shown that membership has enhanced economic efficiency. However, the benefits are far from equally distributed among different sectors of the local economy and have resulted in economic restructuring, often with structural unemployment as an adjustment cost<sup>18</sup>. At the same time, as a WTO membership means enormous opportunities for member state's economies, it also triggers fear and includes a certain element of risk-taking. In such a situation, it is not always easy to play down the risks and instead focus on how to seize the opportunities. An active government policy is therefore needed in relation to a WTO entry, to be able to adopt appropriate policies to handle the resulting adjustment costs. The strategic goal for countries that open-up their markets will always be to make effective use of both domestic and outside resources. That is to try to accelerate independent development and pursue a global economic policy that enhances national economic strength. The only, but sometimes domestically bitter, way to improve international competitiveness lies in swift reforms to overcome the numerous hurdles in the economic structure that restrains the ability to adapt to changes and to compete. The economic development patterns available in a situation where a country opens up is often to become increasingly dependent on TNCs, as a result of increased FDIs, or attempt to promote the growth of domestic enterprises. Less-developed countries that have joined during the last decade have mostly been facing the dual challenge of industrialization and

globalization, and a WTO entry has, in such cases, both facilitated and complicated what is already a huge challenge.

A common problem for many developing countries is their dependence on just a handful of export products, which is, to make matters worse, often commodity-related. This makes the exporting country overly dependent on what is often unstable international commodity markets with unstable prices. In some respects, "*geographic conditions*" leave many countries with few choices other than becoming commodity dependent, at least in the short run. The bigger the country the less likely is the commodity dependence risk, but with the Russian dependence on energy exports as an example of that common rules do have exceptions. The theoretical comparative advantages that a country can possess, originating in the theories of Ricardo, are often to be found in the productive forces, due to nature given factors, at national industrial-level or at the level of the individual companies. From such a position, and to widen national production into a mix of goods and services to be traded, with the aim of advancing to a level of sustainable economic growth, the path is both long and winding. There are practically no examples of countries in recent years that have managed this reorganization on their own, into becoming producers of high value goods. Often the less-developed countries end up with organizing Export Processing Zones (EPZ) where tax incentives are given to companies that establish product assembly in a designated, and often fenced, area. The effect from this is positive, when it comes to employment and GDP generation, but EPZs low wages remains the competitive advantage in relation to other countries.

As a way to improve competitiveness, countries have increasingly started to find suitable countries in their near surrounding to sign bilateral Free Trade Agreement / Area (FTAs). As an exception to the non-discriminatory and most-favored-nation treatment principles, the GATT-WTO recognizes FTAs as a first step toward realizing global-scale liberalization. In other words, the WTO approves the preferential lifting of tariff and non-tariff barriers between the FTA partners. Under the conditions, however, that trade barriers against others are not raised as a result and that tariffs will be reduced to zero within the FTA, within "*a reasonable time period*". Also in a maximum of ten years, trade restrictions must be abolished in "*substantially all sectors*" and liberalization must also target the services sector, as required by the GATS<sup>19</sup>. In the NEA group, Japan has been active in trying to find potential partners, but the problem is the "*substantially all sectors*" requirement. Because of its highly subsidized agriculture, Japan is constrained to look for partners, which either do not have an agricultural sector (Singapore), have similarly inefficient agricultural sectors (South Korea), or run the risk of a WTO challenge if it attempts to largely

exclude agriculture from an agreement (as initially with Mexico). Japan's search for a preferably Asian regional alternative to the multilateral system is currently, and has for a long time been, restricted in this respect by its own overprotective agricultural policy.

Theoretically, if a poorer country concludes an FTA with a richer country, the low wage country is likely to increase its export of more labor intensive products, e.g., apparel, leather products, and agriculture. The richer in the pair is likely to export more of its sophisticated products, i.e. machinery, advanced service and non-basic chemical products. Indicating that it is, first of all, in the already strong sectors that a country will profit the most. After an FTA has been concluded, there will still be products that, already prior to the agreement, were competitive, and for which tariffs and other barriers will remain in place. Instead, and here more important, there will now be a number of other products traded between the FTA partners in categories that, due to reduced tariffs, have gained a price advantage over alternative outside producers. Trade has been “*diverted*” away from what previously were the most efficient producers in the world in favor of the FTA partner – an example of “*trade diversion*”. The forming of an FTA area will also “*create*” trade, as there will be room for increased consumption as a result of liberalized trade and lower prices for imported products – an example of “*trade creation*”.

In the development of trade that follows after an FTA has been concluded much depend on the level of tariffs that reigned prior to the agreement and the partners that had the lowest relative average level of tariffs will probably be able to increase its export the most. As a result of an FTA, there will also be a steady increase in intra-industry trade between the partners. Both countries will mutually export and import a wide spectrum of low-end and high-end products, as well as components and finished products. Also, other sectors of the two economies will benefit, like travel, transport, construction, telecommunications, financing and other service industries. These sectors, outside what is perhaps traditionally considered to be trade, have either very low, no or tariffs, and these effects are therefore often difficult to capture by the detailed statistical analysis that precede FTA agreements. The advantages that are likely to arise from enhanced integration, intensified competition or possible strategic alliances across borders, are hard, if not impossible, to assess. It goes without saying that to make an exact estimation in advance of the positive, as well as negative, outcome of a possible WTO membership, as well as an FTA, is in its details practically impossible. As in other complex systems that are under constant evolution, it will hardly be objectively possible in advance, or later to back-role, what would have happened if a certain step had not been taken. Through a larger market, or enhanced productivity resulting in lower costs, companies

with a potential global competitive edge could be fostered, something that could also have happened without a WTO membership or FTA, although less likely. Together the kind of factors that has just been mentioned is collectively referred to as the “*dynamic effect*” that will arise from trade liberalization. Although, as mentioned, it could be very difficult to make accurate quantitative estimates of the dynamic effects of an FTA, the dynamic effect could in the long run well be much greater than those trade effects foreseen in the statistical analysis.

The most important regional initiative in Asia is the Association of Southeast Asian Nations (ASEAN) with its ten members among the smaller economies in the region. Here, none of the NEA countries are members but an extended cooperation council has been created as the ASEAN group and Japan, China, and Korea are not only neighbors but also important trade partners for each other. The most important regional initiative in Asia, outside of the ASEAN (and ASEAN+3) has become the Asia-Pacific Economic Cooperation (APEC) forum. APEC, however, includes also countries outside Asia, but inside the Pacific, most notably Canada and US. APEC was formed after an Australian initiative, and the US and Canada came to be included as some Asian countries wanted involvement from the other side of the Pacific to counterbalance Japan that were economically very strong at the time. Japan had previously been promoting a similar forum, but APECs first meeting was held in Canberra in 1989. In all APECs membership accounts for more than 2 billion people and more than half of world’s GDP. Due to great political-economic diversity among members, no one expects it to see deep integration along the lines of the EU. Instead, much activity has been focused on business facilitation, such as streamlining trade procedures. Progress on trade and investment implementation has been uneven. Agriculture is also a highly sensitive issue here, and Japan has successfully lobbied to avoid having agriculture included from the accelerated liberalisation commitments at several leaders’ meetings.

The growth of multilateral regionalism outside of Asia and the failure of the WTO Ministerial Conference in Seattle 1999 encouraged Asian countries to take a second look at regional economic integration schemes. The previous idea of East Asian Economic Caucus has been somewhat revived in the form of the ASEAN+3 initiative. The subsequent WTO failure in Cancun in 2003 gave another push to many nations across the globe to more seriously consider to negotiate bilateral agreements as the chances for a multilateral agreement started to fade<sup>20</sup>. When adapting bilateral agreement co-operation is particularly needed in sectors where countries are already internationally competitive, yet severely competing with each other. If so, this is probably a sector where inefficient overcapacities exist, and where intra-industry trade is underdeveloped. To stay competitive in the long term, cooperation and specialisation / restructuring in

such sectors is likely to have a positive pay off. In due time allow this kind of restructuring to happen, could be a hard medicine to swallow for the parties that end up on the losing end.

When discussing international competitiveness and trade, it is of fundamental importance to establish to what extent products from different countries really compete. When the Japanese export is compared to the Chinese export, they at first appear to consist of relatively similar products. Still the two neighbors do not always really compete as of the roughly 10 000 kinds of items exported from Japan and China to the US, about 20% can be seen as competing (RIETI, 2004-06-07). However, it should also be remembered that this value is on a constant increase, from a one-digit value ten years earlier.

The proof that a process of increased interest in each other's markets is ongoing is demonstrated by the fact that the four Asian neighbors accounted for about 16% of the global trade volume in 2003. The global trade volume for the first time exceeded USD 7 trillions, while the NEA trade volume stood at just under 1.2 trillion (see also Table 1.4). Mutual trade in the region is increasing faster than world trade, having advanced from a 13% share in 1990 to about 24% in 2003. Compared to world trade that rose by just over 5%, the intra Asia trade rose by over 16% during 2003, revealing the dynamics of the region compared to the other parts of the world (ADB, 2004-05-07). Among the individual NEA countries, Korea is the country with the clearest focus on its neighbors as trade partners with over 35% of its trade inside the region. Japan is not far behind with 31%, China with 31%, with Russia standing out here on 10%. Highest share of its trade inside this group of countries have two near "outsiders", Taiwan with 50% and Hong-Kong with 60%.

In relation to the potential of trade between the four neighbors, this figure could probably continue to increase considerably. Compared to the level of internal trade inside the NAFTA region, at around 45% and over 60% among EU members, the NEA group is still lagging behind considerably. It is in this perspective that the demands from local business circles inside NEA and among other Asian countries for the extension of FTAs, between neighboring countries in the region, should be seen. It is probably so that there are a number of win-win situations that can be released and it could be time for the ASEAN + 3 countries to unite for the common benefit and for increased prosperity (KITA, 2004-05-18).

To allow the full potential of the form of integration achieved through in FTA, open and transparent markets are needed to make room for market mechanisms and their dynamic effects. That could include issues such as taxation treaties,

mutual investment agreements, mutual recognition of standards and certification, intellectual property rights, promotion standardization of customs clearance and procedures, implementation of other trade facilitating measures, mobilization of capital, trade in services, mobilization of labor and open-up government procurements. Many of such measures are meant to improve the confidence of firms in the partner countries, as well as from countries not included, to invest in the economies of the two FTA partners.

**Table 1.4. Trade Between Russia, Japan, China and Korea; 1998 & 2003**  
(values in million USD)

	Partner	1998 EXP	2003 EXP	% of Exp.	1998 IMP	2003 IMP	% of Imp.	% of Total
<b>Russia</b>	Japan	2 194	2 250	2	819	1 880	3	2
	China	4 146	8 397	6	1 167	3 307	6	6
	Korea	508	1 227	1	1 010	1 330	2	1
	NEA group	6 848	11 874	9	2 996	6 517	11	10
	Rest of world	67 312	121 843	91	56 000	50 898	89	90
	Total	74 160	133 717		58 996	57 415		
<b>Japan</b>	Russia	977	1 765	0	2 892	4 237	1	1
	China	42 688	117 208	25	38 820	78 163	20	23
	Korea	15 363	34 806	7	12 076	17 903	5	6
	NEA group	59 028	153 779	33	53 788	100 303	26	30
	Rest of world	329 108	318 217	67	226 846	283 148	74	70
	Total	388 136	471 996		280 634	383 451		
<b>China</b>	Russia	2 818	6 311	1	4 016	10 226	2	2
	Japan	52 262	71 495	14	51 634	101 748	19	17
	Korea	21 614	26 002	5	14 448	55 180	11	8
	NEA group	76 694	103 808	21	70 098	167 154	32	27
	Rest of world	183 387	391 376	79	175 274	356 628	68	73
	Total	260 081	495 184		245 372	523 782		
<b>Korea</b>	Russia	1 050	1 659	1	982	2 522	1	1
	Japan	11 069	17 276	9	16 537	36 313	20	14
	China	19 549	49 764	26	6 601	24 644	14	20
	NEA group	31 668	68 699	35	24 120	63 479	35	35
	Rest of world	100 634	125 118	65	69 161	115 347	65	65
	Total	132 302	193 817		93 281	178 826		

**NB:** - “% of Export/Import and % of Total” – referrers to 2003 only.

- All figures related to China include Hong Kong.

- Total China figures are given with exp/imp between Hong Kong and China excluded.

Source: UN Statistics Division – Commodity Trade Statistics Database;  
(www.un.org).

The above-mentioned ongoing restructuring of international manufacturing industries has lead to resources that are moved around the world, in search of their optimal use. At the same time what mostly still is, but more so used-to-be, labor intensive industries have been, to a large extent, transferred to the developing countries from what is now considered to be developed countries.

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However, the remaining labor-intensive industries that are still working in developed countries are increasingly, and probably unavoidably, ever harder hit by imports from lower labor costs countries. The result of such clashes of interest is increasingly often the background to cases when developed countries resort to protectionism as a last protective measure. In international trade, the use of the words “*dumping*” and “*anti-dumping*” has increased in recent years, although the origin can be dated back to very early days of international trade. A dumping case, according to the definition given by the WTO, occurs when imports are sold in a foreign market at a lower price than the normal price, and thus causing damage to producers in the importing country. One major problem involved is the setting of the “*normal price*”. For countries that are considered to be market economies, “*normal prices*”, are derived by comparing prices in the domestic market of the export country. For what is considered to be “*non-market economy countries*” the process of setting this price becomes much more complicated and less precise<sup>21</sup>.

During most of the first forty years of multilateral trade negotiations under GATT, tariffs have been lowered considerably, and instead made the anti-dumping actions a policy seen by some as a way to increase the protection of local manufacturers. Alternative forms of protectionism, with different forms of non-tariff barriers, has, from time to time, been gathering momentum when the use of conventional tariff barriers does not function as before.

The idea of holding back the import of products by way of using anti-dumping actions was seldom followed through until the 1950<sup>22</sup>. An annual average of thirty international anti-dumping lawsuits were opened in the 1950s and 1960s, about forty in the 1970s, surged to 174 in the 1980s. (MOFT, 2004-04-30). The period of eight and a half year, 1995 to June 30, 2003, witnessed 2284 anti-dumping investigations launched by WTO members, setting the modern time average to 270 per year (WTO, 2004-04-15). Most frequent to use the anti-dumping weapon has been developing countries and regions using it to counterattack the damaged caused to local industries by what has been considered to be unfair trade. India, Argentina, and Brazil are examples, where India is leading the list initiating 344 cases from 1995 to 2003. A number that clearly exceeds that of the second country on the list, the US, which had filed 308 cases during the same period. In later years the US has become increasingly active in this respect and in 2001, alone, launched 74 anti-dumping investigations, a figure that can be compared to 14 cases in 1995 (WTO, 2004-05-15).

Generally it is labor-intensive products that are subject to anti-dumping complaints, with products such as metal products, electrical products, and



textiles to top the list. If the exporter feels discriminated by an anti-dumping initiative of an importing country, the enterprise, via its trade ministry, can bring the case up to the WTO dispute settlement facility for arbitration. When the case has been investigated, if not settled through bilateral negotiations in the meantime, an anti-dumping case will be ruled. The import country often sets out an anti-dumping tax (import tax), that from its point of view, corrects the price picture and/or to protect its domestic industry. The result of the investigation could be that an anti-dumping tax is approved, but perhaps at a lower/higher level than the one originally imposed. If successful, from the importers point of view, an anti-dumping complaint will result in an opening for unilateral powers to impose anti-dumping taxes for the number of years stated in the ruling.

#### **1.4.2. Neighbor relations**

In the NEA “*region*” being covered here two of the five, Japan and Korea are long established market economies; two, China and Russia are in the process of transition from central planning towards a market economic status. The fifth country in the group, North Korea, has for long remained one of the most enclosed countries in the world about which much less is known with any certainty, at the same time as it the economic “*Lille Putt*” in the region. Still it is on North Korea that much of the regional neighbor relations are being centered. What has become known as the “*North Korean nuclear stand-off*” is currently the most pressing international issue in the region. Multilateral talks, called the “*six party talk*”, on North Korea commenced soon after the US has stamped North Korea as a country belonging to the “*axis of evil*” and its eventual capacity to produce nuclear weapons lifted this issue near the top of the international political agenda. At the same time the severity of the matter has brought the other countries in the NEA group together at the negotiation table. Consequently, discussions here are looked upon with a sincerity that would have been difficult to establish otherwise. Three of the countries share a land border with North Korea and therefore takes special interest in this matter, while Japan, without land border, is instead located in the direction where some North Korean test missiles have been aimed. From the whole group of countries, there is a strong interest in maintaining the non-nuclear status of the Korean peninsula. Seeking a political resolution to the prolonged conflict over North Korea's nuclear ambitions through the six-party talks, they also involved the United States. The Russian side especially also stress the security issue of North Korea, but a settlement of the ongoing conflict could not be reached without taking into consideration the interest of all parties involved. It is not a very advanced guess that the United Nations will be committed to a future role in finally resolving the conflict.

The concerns are based on the fact that if North Korea were in possession of nuclear missiles, it would gain a disproportionately strong position in the region. This would change the basic configuration of the geopolitical situation. It is not likely that this has happened, but there is also a growing fear in the region, or respect, in relation to the growing strength of China in the region. The rise of a big power always causes concerns, especially among neighbors, but for such an important player, changes in strength will also influence the global security network. When it comes to China, having the world's largest population and already being a considerable military force, it is easy for observers to talk about a possible "*China Threat*". This worry has already been voiced in the US, Japan and India. It is not only the economic might of China that is growing rapidly; it is also the military strength that is growing. Still it is probably undeniable that China's general military technology and capability is something like a decade or two behind that of the US. With the Soviet Union falling apart and the transition problems faced by Russia, China is already one of the world's most powerful countries, eventually second only to the US (US CFR, 2004-05-19). China's road to become a real big power, if economic development continues, could prove surprisingly short. Already long before the middle of this century, it could be considered a mid-level developed nation and by holding the undisputedly largest population in the world, it would find its new future position in the rank of what would by then have become a pair of global superpowers.

However, China has now been adopting a comparatively open policy for twenty-five years. Deep involvement in many of the global issues, including a working relationship with many international and regional organizations, are strong arguments opposing the "*threat*" of China and instead indicate a "*peaceful rise*". China has, probably intentionally, been trying to walk a different path than the one previously followed by the big rising powers. It has, during its transition years, largely attempted to observe existing international laws and regulations and has proven obedient by joining organizations like the WTO. If this path will be continuously used over time remains to be seen. However, if it will prove successful, it could result in a form of win-win situation for both China itself as well as for its neighbors, but also the world at large. What makes common understanding hard to apply when discussing the two opposing positions about the threat is that this kind of radical shift in positions in the world order has normally taken 100 years and never something like 15 - 25 that will be the case here.

Inside the region, there has been a gradual improvement of relations between China and Japan, the economically two most important nations in NEA. This has been an ongoing trend over the last ten years and has also included both countries relation towards Korea. Relations across the Korean Strait have grown

strong enough to absorb acts of near provocation as when Japanese Prime Minister Junichiro Koizumi's has been paying homage at the Yasukuni Shrine<sup>23</sup>. It would seem like a small step for the prime minister to retreat from this tradition, to visit the shrine, to improve foreign relations. Such an initiative would also ease tension with other neighboring countries, as the negative reaction to the Yasukuni tradition is as strong for Korea, Singapore, Indonesia and the Philippines<sup>24</sup>. However, the current (ab-)normal state of "*cold politics and warm economics*" in bilateral relations has proved stable enough not to derail by this. However, as a result of their visits, there has not been any official meetings at the highest level since 2001 and all meetings since has been kept short and on the sidelines of large conferences<sup>25</sup>. At the same time, cooperation in wider fields between the two big neighbors is waiting to really take off, as it is difficult for such cooperation not to be influenced by political factors and by the public sentiment. A widening of cooperation into more fields of common interest would both foster mutually beneficial economic relations and safeguard future political and diplomatic development. It still remains to be realized on both sides that a peaceful development of China is not necessarily a threat, but could instead act as a catalyst that can also help to further strengthen the Japanese economy. China in 2003 took an important unilateral step to improve relations when Japanese visitors were being exempted from normal visa requirements. Although high level state visits have been suspended, cooperation on lower levels is gaining momentum on a large scale.

The cooperation between Korea and Japan has found it easier to overcome a dramatic history. Since the Korean War in the mid 1950s relations between the nations in the region have seen improvements in practically all directions. However, there are still no peace agreements between Japan and Russia, as well as between the two Koreas. Seen from the perspective of the dramatic historic past, relations have slowly improved across all borders. The rise in importance of international business and the very rapid rise of the war against terrorism to a global issue, show that geopolitics can change quickly. Sudden changes in the outside world continue to influence the situation and, from time to time, disturb the setting of the agenda. Other difficult issues to come to terms with have been former territorial disputes, Il legal labor migration, human trafficking and the smuggling of drugs and goods. As understood, it is not self-evident anymore that states themselves and their political elite set the agenda as the world has become more complex, interdependent, and at the same time, fragmented.

The Russian position in the region is somewhat different from that of the other four. The Russian Far East is the least populated land area in the region and with the country's political, economic and population centers being located 1 000 of kilometers away. At the same time, it is well known in the Asian region that there is a considerable potential for the export of raw materials to raw materials

in starved countries in Asia. Potential foreign investors in the exploration of oil, gas, coal, and various minerals in eastern Siberia, is something that has several times been mentioned by the Russian government as one of its priorities. Investments are not only hoped to find their way to the Russian Far East from its Asian neighbors, but also from the countries across the Pacific like the US and Canada. So far this has not come to materialize to any larger extent, as the problems that have faced early investors have proven to be much larger than the potential profits from their investments.

However, the constant search for energy security among the NEA countries is one of the classical fields of geopolitical competition where states and companies remain the most important actors. Especially so in the case of Russia where energy is the most important asset for the future and already the outstanding earner of foreign currency. In later years world supply of energy has been below demand, which has not only raised prices, but also given the geopolitical importance back to energy that it had in the late 1970s and early 1980s. In NEA, the discussions concerning the laying of pipelines in one or the other direction has come to enhance the Russian position in the region, and has, perhaps, created a new reason for rivalry between China and Japan

One initiative that has been missing in the region that could have helped to overcome the high-level communication problem between China and Japan, has been a cooperation organization for the NEA region. In this respect, the six-party talks on the North Korean nuclear issue has opened up an opportunity for the NEA countries to organize high-level meetings. Preparations for these meeting, as well as the actual meetings, have opened a forum that, hopefully, is there to stay also after the current North Korean stand-off has been resolved.

In discussion about international relations the NEA region, the US interest in the region cannot be overlooked. Security is the prime US interest, both here and elsewhere in the world. Previously it was the Russian Far East that used to be a considerable concern, but now that role in the region has been taken over by North Korea. On the other hand, an increased Chinese influence in the Russian Far East would not serve US security interest and especially not US interest in Russian energy resources.

## **1.5. Energy**

Too many energy is equal to oil, which is not really correct as coal continues to supply more energy than oil. At the same time, oil remains the world's most important traded energy resource and is to its reserves a relatively concentrated

resource. By a wide definition of world energy resources, including known oil, gas and coal, reserves compared to world energy consumption, reserves are well over 100 times the yearly consumption, with coal making up about 60% of the reserves (BP, 2004-06-15). During the years since the first major oil crisis in the beginning of the 1970s, world energy use has gone up by around 60%. During this period, oil production has increased from 2.900 to 3.600 mtoe and with coal production having increased from 3.800 to 5.300 mtoe (IEA 2004-07-14)<sup>26</sup>. World oil consumption by mid-2004 was in the range of 82 million bbl/day or 30-bn bbl/year<sup>27</sup>. Oil demand in the summer of 2004 stood at its highest since 1980 with OPEC countries producing at nearly 28 million b/d, or just over 1/3 of world production<sup>28</sup>. The biggest single producers during 2003 were Saudi Arabia and Russia with 8.7 and 8.6 million bbl/day, but both having increased production during 2004 to about 10 and 9.1 million bbl/day, respectively. The most significant change in supplies over the 1998 – 2003 period is the Russian increase in production, which has supplied near 50% of the increase in world supply during this period. Currently several big producers of oil have reached plateaus from which they are likely to fall back, including China, Mexico, and Malaysia, leaving FSU states and OPEC countries as the ones with spare capacity for the years to come (PFC Energy, 2004-09-09). The US stands out as the largest consumer, at around 20 million bbl/d, above even the combined production of the two biggest suppliers. The US consumption is also clearly larger than the pair behind, China and Japan, consuming about 6.3 and 5.5 million bbl/day respectively, which is about double the next consumer, Germany at 2.7. Currently there is technically no short- and medium-term problem on the supply side for oil. Oil found since the first oil crises in the early 1970 is nearly twice the volume consumed during these 30 years. At the 2003 level of consumption, known reserves correspond to about 41 years of consumption, compared to 29 years in 1980.

For what is now about five years, energy prices have been more or less stationary on a high level. First, prices were lifted by increased economic activity in the larger market economies. Then the high level has been maintained largely by a continuous complicated situation in and around Iraq, while increasing imports, to, first of all China, have made demand further out-strip supply. The only country in the NEA group that has been able to fully profit from this is Russia, as the only energy net exporter, while the other four are all net importers of energy. As a matter of fact China, during 2003, even overtook Japan in import volume to become the second largest importer of energy in the world after the US. With continued problems around Iraq, and no indication in the short-term of any major changes on the demand side, it is not unlikely that oil will take long to fall off to a level around USD 25bbl. What has changed in later years is not only that the oil companies can charge higher prices for their oil, but also that costs

around oil extraction has been on an upward trend as the new oil that is being explored is often found in more difficult sites than before. This could be further away from available infrastructure (e.g. western China) increasingly difficult climate (e.g., Siberia) or further offshore (e.g., deeper waters). As oil prices, by tradition, are quoted in US dollars, the simultaneous fall in the value of the dollar that has been seen during the last two years has made rising prices look increasingly dramatic. Additionally, other factors like rising steel prices and shipping rates has put further upward pressure on consumer prices. It must not be forgotten that the increased oil prices also has a widespread effect on the level of other energy prices. In the case of coal, the price per ton for internationally traded standard coal has risen by about 100% from the early autumn of 2003 and one year forward. There are of course specific supply and demand conditions that influence price levels for different energy commodities, but the connection to especially the oil price is both strong and evident.

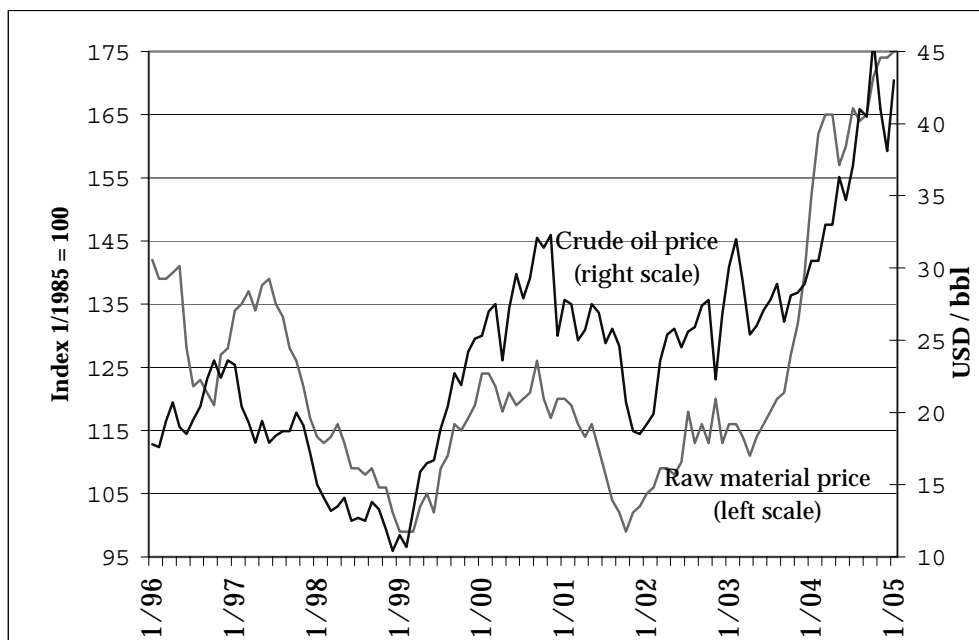
Russia is the only country in the NEA region with a surplus in production of energy, as less than 60% is being consumed domestically, which leaves much for export. The other four countries in this group are all net importers of energy. In the case of China the import dependence has increased from about 5% ten years ago to the current level of about 10%, while the US, as the world's greatest importer, imports about 25% of its energy needs (UN-Energy, 2004-10-14). At the same time the efforts from Japan to conserve energy has paid-off as the oil consumption in relation to GDP is by far the lowest in the region. To generate 1 USD in GDP in Japan takes about 130 grams of crude, compared to 230 grams in the US, 460 grams in Korea and 800 grams in China (ANRE, 2004-10-25).

What is discussed here are only the production and consumption of commercial energy. The use of energy from stocks, or the building up of stocks, not only influences the figures between years, but also generates a certain degree of confusion between production and consumption statistics. Additionally, generation originating from, e.g., bi-products, biomass, wind-energy, waste burning and conventional burning of wood can add to the problem. Despite this, it is the by far most important sources of energy for the world, as well as for the countries focused upon here, that are listed in Table 1.5.

China, and partly Russia, is still dominated by their big national oil companies, which is the general picture in the world on the production side. An approximate figure for the world is about 50% of world oil production is transported outside its country of production and the company that produced it (BP, 2004-06-19). It is in this, the second layer, as buyers, transporters and refiners of the oil that the big international oil companies still play a dominating role. In this respect, the international oil market today carries the reminders of

what it looked like in the years before the forming of OPEC and the first oil crises. That was when seven big international companies dominated most aspects of world oil production and its trade. That this pattern partly remains is demonstrated by the fact that Shell and ExxonMobil were the world's biggest in signing contracts for oil shipments in the two largest ships categories in the world during 2004 (SSG, 2005-01-13).

**Table 1.5. Average Oil and Raw Material Prices Monthly 1996–2005**  
(USD/bbl)



Source: UNCTAD, Commodity Price Bulletin (UNCTAD2, 2005-01-31)

Some aspects, in relation to the NEA group, that must be remembered is the generally high level of coal dependence, and especially so in China, that is well over the world average. Also, the production and use of natural gas as an energy source is very different inside the NEA group of countries. In Russia, natural gas makes up about 50 – 55% of primary energy production while in China, the only other country here with any major findings of natural gas, the same percentage is 2 – 3% (UN-Energy, 2004-10-14). Instead, the use of nuclear energy is considerable in both Korea and Japan. These general statements for the different countries still leave room for industrialised areas inside any NEA country, with energy intensive heavy industry, to consume energy on a US or Canadian level. At the same time, rural farming areas consume far below the national average.

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In the longer term, it would probably benefit the countries in NEA to cooperate more closely in the energy sector. There is a need for future political strategies and framework conditions to be in order to support the market development, and to ensure a stable supply of energy as possible, while developing some form of energy consumers, cluster. This includes a discussion on how and to what extent it is possible to coordinate strategies for the energy sector. At the moment the NEA countries have adopted different positions in the WB discussions about energy, about the Kyoto protocol and when it comes to the Energy Charter Treaty. If such positions could be hard to adjust, a suitable starting point for cooperation could be a strategic energy reserves that China have decided to build up in the near future, something that is already held by Japan and Korea. However, a common clear visions and long-term strategies are required as the region currently relies heavily on multinational oil companies and sea routes that can be interrupted. It still remains to be seen if an understanding can be developed and if some form of integrated energy market can emerge among the three big buyers in the NEA group. China, Korea, and Japan in the NEA group has a common interest in securing supplies for the future while reforming the domestic energy industry to raise efficiency. All three countries have restricted freedom to act in the energy sector due to environmental demands, e.g., to limit both local pollution and CO<sup>2</sup> emissions on the national level. Restrictions that will probably make increased energy efficiency and conservation the cheapest of all measures available. At the same time, to ensure the fulfilment of future energy demand, a continued diversification in both production and sourcing must be promoted.

Despite this seemingly ideal fit between a large potential markets and a large nearby surplus, East and Southeast bound deliveries from Siberia have remained small. So far, decision-making in Russia has remained clearly centralized to Moscow. In the Russian capital, the aim seems to have been to fulfill the needs of Europe than that of Siberia's more neighboring countries like China, Korea and Japan. From the point of view of NEA countries, Russian hydrocarbon resources in the Far East are relatively near and large enough to attract considerable attention. In the chapter about Russia, a special sub-chapter has been devoted to the discussions around the building of pipelines for oil and gas to either China or Japan, and will therefore not be given any lengthy coverage here. It must not be forgotten though that it takes a number of years to build a long distance pipeline and furthermore, everything surrounding large pipeline project is not all rosy. A large diameter pipeline will mean that huge areas will be used up by the construction, and, if laid on the ground, it will curtail the possibility of movement for people as well as for wildlife in vast areas.



**Table 1.6. Selected Countries Energy Consumption by Type 2003&1993**  
(mtoe)

1993						
	Oil	N-gas	Coal	Nuclear	Hydro	Total
Russia	189	374	141	27	40	771
Japan	251	51	79	56	24	461
China	141	15	577	0	33	766
Korea	79	6	26	13	1	125
Brazil	63	4	10	0	53	130
India	63	14	128	1	16	222
UK	84	58	53	20	1	216
US	789	538	499	145	63	2 034
RestofW .	1 480	809	655	233	304	3 481
<b>Total</b>	<b>3 139</b>	<b>1 869</b>	<b>2 168</b>	<b>495</b>	<b>535</b>	<b>8 206</b>
2003						
	Oil	N-gas	Coal	Nuclear	Hydro	Total
Russia	125	365	111	34	36	671
Japan	249	69	112	52	23	505
China	288	31	807	10	64	1 200
Korea	105	24	51	29	2	211
Brazil	84	14	11	3	69	181
India	113	27	185	4	16	345
UK	77	86	39	20	1	222
US	914	567	574	182	61	2 298
RestofW .	1 681	1 149	688	265	323	4 108
<b>Total</b>	<b>3 636</b>	<b>2 332</b>	<b>2 578</b>	<b>599</b>	<b>595</b>	<b>9 741</b>

Source: BP World Energy Report 2004 (BP, 2004-07-10)

With the visits of both the president of Korea and the premier of China to Moscow inside a week in September 2004, and with Putin due in Japan in late 2005, the eastern window could perhaps be made to open. Additionally, there are also other potential export products among energy resources outside oil and gas in Siberia, which are normally the only ones focused upon. Other such examples that could be of interest to NEA neighbors could be the abundant reserves of coal, uranium, different minerals and forest resources, while hydropower, peat, and geothermal resources could well be exported in the form of electricity.

It is a strategic question for Siberia's Asian neighbor countries to consider to what degree they want to bet on developments in Russia to be stable enough to secure future deliveries. The present Putin government can, from the one side be said to develop in a not fully democratic way, in a European sense, while becoming increasingly stable. On the other hand, both Belarus and Latvia has, in recent years, experienced how damaging the Russian oil and energy weapon can be when it comes into use. The handling of gas deliveries to Belarus during the winter of 2003 – 2004, by the Russian state-owned gas monopoly Gazprom, showed how powerful the control over the tap to energy deliveries is. This is an incident that must have given rise to second- thoughts among potential customers elsewhere. To build up a large dependence on Russian energy could place Asian countries, or some regions in these countries, in the same position as some smaller countries in Europe.

To shift between the uses of different energy resources is seldom very easy. Investments made into the use of one type of energy often make consumers reluctant to change source, at the same time as many larger consumers are protected in the short run from price fluctuations by long-term contracts with suppliers. This gives a time lag until higher price levels will be really felt, but in the longer term, it is often when investment decisions for the future are to be taken that other energy alternatives are being considered seriously. Regrettably the development and efficiency of alternative sources of energy have still to reach a level where new technique can be economically sustainable at an energy price level below a USD 30/bbl level. In such a situation, it would have taken a strong belief from an investor to proceed with such an investment just a few years ago. However, any such initiative would have been richly rewarded at the price levels during 2004.

As for future world consumption of energy, oil will remain the world's most important traded energy resource for another 25 years to come. From some time, around 2030, oil will start to fall off and at about that time gas is likely to have passed coal in importance to become the second most important energy resource. The second big change to come is that the reserves of non-conventional oil resources, with much still to be discovered, are at that time likely to have become larger than conventional oil reserves. This will enhance the position of e.g. Canada, as its large oil-reserves in the form of oil-shells will have come into full commercial use by that time. The increased use of both non-conventional oil resources and natural gas could not only prolong the energy crises scenario, but also these and other petroleum-based resources are nonrenewable. Inside a timeframe of about a generation from now, a new basic energy system for the world must be at least on its way to be implemented. If not, another big energy crises will soon be approaching (T&E, 2004-09-10).

In later chapters that cover the individual countries, there will be a number of reasons to come back to discussion concerning energy supply and energy security.

## **1.6. Transport**

Transports are often ascribed a role as both generator and facilitator of economic growth. In the previously discussed internationalization of manufacturing, the rapid and simultaneous development of transport and ICT is somewhat being taken for grant. However, it is difficult to establish the extent of development of transport capacity and how shortened transport times have helped to enable the globalization process. The correct view could be the reverse; that demand for increased transport capacity and speed made the transport sector develop, e.g., the mega ships that are sailing around the world with containers on set schedules. Transport's contribution as a facilitator of the globalization e.g. falling prices, increased competition, increased security, complete internalization inside shipping, much improved logistic services, wide-spread computerization, has obviously contributed massively. The parallel development inside the ICT sector that has made instant long distance communication and control possible, at lower costs, among an abundance of other achievements, has greatly supported continued globalization and the development to the transport sector.

On land, the role of build-up transport infrastructure becomes crucial as facilitator of transport and trade. In the transport of large volumes of energy resources, e.g., inside NEA, the building of new infrastructure has been turning increasingly expensive. At the same time, mounting costs have made the largest projects practically impossible to be financed by one state alone. A development that can help to establish wider cooperation and friendly relations between countries in the region, but also risk creating new divisions if ideas do not work out as expected.

One of the major problems affecting the transport sector, and other service industries, is that the product, i.e. transport services, cannot be produced beforehand and stocked until demand kicks in. The mere size of a transport system is not a guarantee that it will cope with the demand from the industries as well as from the passengers who are using it. Therefore, adoptability becomes a major factor of concern in transport; at the same time as a good planning, optimal use of available transport capacity will be as important. In this field of "*logistics*", much still needs to be improved, especially so in the two transition economies of the NEA group.

The most important shifts that have occurred in the transport sector inside of the NEA countries are occurring in Russia and China. Here there is a radical shift away from the strong position held by railway transport to roads and the use of trucks and away from state control over the different means of transport in the direction of private ownership. This involves a transformation of a system where transport is centrally planned previously; and away from a situation where relatively few, but large, producers dominated. At the time manufactures, as well as commodity extractors, all had pre-planned volumes to be produced and destinations to where the production should be dispatched. This system is still under forced revision, as it is adapting to market economic conditions. Now, the planning horizon is generally much shorter, the number of suppliers and buyers has multiplied, at the same time as the average size of consignment has fallen dramatically. A combination of processes that favors the advantages given by the use of trucks instead of rail.

In respect of domestic transport, the four countries in NEA are ready to be divided into a group of developed countries with Japan and Korea and the transition group with Russia and China. The first two have a long tradition of a well, spread car ownership and are both to a large degree dependent on road transports also for freight. The pair of transition economies could at best be said to be aiming at the same situation. Here though, the size of the two countries makes it unlikely that road dependence, neither passenger transport nor freight, will reach anywhere near that of most developed countries. In Japan and Korea, on the other hand, the construction of new roads has long since found its established state and tax-funded system of financing. Road financing is still far from having a lasting system in the transition economies. The possible privatization of roads and the building of private roads have been discussed as an alternative to the failure of the state road agencies to maintain and build roads in line with increasing car ownership. Both Korea and Japan have reached maturity in car ownership and have instead become large exporters of second-hand cars to especially Russia. In both China and Russia, private car ownership was, more or less officially discouraged, until some ten years ago, giving few incentives to increase their very low levels of road density. Both countries are also among the biggest in the world with vast sparsely populated areas that must pay a considerably higher share of product prices to the transport sector. Low population density in combination with the long distances involved multiply the needed investments to eventually upgrade the transport system in such areas, as the same time as usage is bound to remain low.

To remain attractive for investments from both inside and outside the region, close cooperation with the near neighbors in the NEA region is critical. In later years, Korea has become very active to negotiate; attempting to conclude road

and bilateral aviation agreements with countries that are important to its development plans. Any global or regional ambitions are currently impossible to fulfill on its own for any country in the region, and especially so if it does not include China and Japan.

Concerning international trade, it is the seaborne movement of goods that remains the by far most important. During 2004, seaborne trade is forecasted to reach about 6 bn tons, accounting for about 90% of international trade by volume, up by nearly 50% over 15 years. Shipments of crude oil and oil products are the dominating single category, with different dry bulk products together making up near half the total volume. Out of this half, or 25%, is related to the steel industry's raw material needs and the shipping of finished products. With China becoming an increasingly important importer of raw materials, demand for ships has been near capacity during the last few years. With the rising importance of China average distances of shipments has increased between producers and consumers, further lifting the demand for capacity. Also, the Chinese container volume has increased rapidly, by approximately 1/3 per year over the last few years, setting the turnover to 35 million TEU for 2003 (SSG, 2004-07-28). Also, for manufactured products, the voyages are longer than before, further enhancing the need of capacity, which has resulted in a sharp increase in charter rates. As a result, shipping costs in some sectors have nearly tripled in just one year (Baltic Exchange, 2004-08-17).

## 1.7. A systematic country approach

In the general introduction, ending here, it has largely been changes occurring as a result of the ongoing globalization process that has affected the NEA countries, as well as other countries in the world, have been given a general overview. The focus in the following will shift on to the individual countries in the NEA group of countries. The five main chapters are presented in the order of Russia, Japan, China and South Korea; with only a very brief chapter covering North Korea. Leading to a final chapter; Discussion and Conclusions.

Each of the abovementioned country chapters starts with a **General Introduction** that includes a brief summary of major development over the last few years, but concentrating on 2003 and 2004. This is an introduction to the following subchapters that are headlined as **Economy, Trade, Energy and Transport**. The aim behind the selected subchapters is to describe not only the conditions forced upon, but also created by the different countries, seen from these respects. Foreign trade is at the centre of most issues mentioned, as trade greatly influences the economic development in this group of increasingly trade

dependent NEA economies. Trade is the generator of money economic wealth, physically conducted by way of transport and driven by energy.

To their nature these subchapters for the four countries will look slightly different. Energy in this region, to a considerable degree is an important item on the import balance, case for Russia on the export balance. As energy in of Russia is extremely important, it is therefore given a longer description. In the same way the description about shipbuilding in Russia is very small compared to the one under Korea and the description of Free Trade Agreements is large for Japan, but not so for China and Russia. Instead, the chapter on China includes a longer description about trade of textiles, which is an important Chinese export item. Also the chapters about economic issues, have slightly different focus in the different countries making, the chapters reflect what is seen as important aspects for each country. Taken together the content of the chapters are intended to give a solid picture of both the latest development and the current situation in various sectors. All with the aim of giving a wider coverage to issues that have been found to be more relevant for each individual country, the descriptions, still maintains its framework of a systematic country approach.

## **2. Russia**

### **2.1. Introduction to Russia<sup>29</sup>**

Since the mid 1980s, after the appointment of Mikhail Gorbachev as Secretary General of the Communist Party, changes in, first, the Soviet Union, and later, Russia have speedily advanced. The processes of openness (glasnost) and restructuring (perestroika) that were initiated at the time contributed to the gathering of the momentum that led to the final break-up of the Soviet Union on December 8, 1991. From then on, the Russian Federation, with Boris Yeltsin as its new leader, along with 14 more former Soviet states, created a new political geography in this part of the world. However, in Russia the restructuring process continued under Yeltsin, and in 1993, a new constitution was approved by way of public election. At the same time, the first democratic parliament, the Dumas, was elected<sup>30</sup>.

The reforms that have been introduced have structurally changed society, with the intention to turnaround the formerly centrally planned system to transform into a market economic system, inside a not too distant future. Reforms adopted during the early transition period, included measures like mass privatization, legal reform, the creation of financial markets, currency convertibility, and much more. Although the reforms were uneven it did make market reforms take deep root in the former centre of communism. The reforms started to show progress in 1997, when GDP turned positive for the first time since the start of reform. Soon though, the reforms were to face its biggest setback, when in August 1998, the value of the stock exchange collapsed along with the value of the Ruble. Few western companies abandoned the country in the aftermath of the crises and instead continued to focus on the potential buying powers of the near 145 million population and the abundant and largely untapped resources of oil, gas, minerals, and timber in Russia.

Already in 1999, and much as a result of increasing world oil price levels and a much devalued ruble, economic indicators again showed positive signs and the growth trend came to be reestablished. It was at this stage that Vladimir Putin was first named Premier Minister and by the end of the year offered to take over as President. It will, first of all, be the years of the 21st century, all under the rule of Putin as President of the Russian Federation, and especially 2004, that will be covered here.

### **2.1.1. Introduction to the Russian Economy**

President Putin's government under its, until the spring of 2004, Premier Kasyanov, in cooperation with the pro-Putin Duma, has managed to introduce a number of fundamental reforms during the president's first term, 2000 - 2004. Examples of the changes that have taken place are, the introduction of the flat income tax, a new system for profit tax, the new Land Code and the new legislation on liberalisation of the currency handling. What is probably the most admirable achievement of the government has been its ability to balance the state budget, and even run a surplus, during its entire mandate at the same time as international borrowing has been sharply reduced. As a result of the devaluation of the Ruble in August 1998 and with strong support from steady, and steadily higher world oil prices, the Russian economy has grown during the last five years with the stock market hitting new highs. During the time since Putin came to power, the real per capita income has continuously improved, the national hard-currency reserve has reached its highest level ever and inflation has been kept modest, or on a slow decline.

In parallel to these positive developments on the side of economic reform and growth, Russia's political system has become less pluralistic over the years of the 2000s. During his first term, the president did very little to strengthen weak and fragile democratic institutions. He instead actively weakened them still further. The brutal and ineffective war in Chechnya has continued uninterrupted and the state apparatus has acquired de-facto control of much of the written media and major national television networks. Still, Putin has been very clear about the future development of Russia by stating:

*"Russia made its choice 10 years ago. Russia wants to be, and will become, a democratic, socially oriented state with a market economy."*  
(President Putin, 2004-09-26, RFE 2004-09-27)

Two of few economic factors that fall on the negative side are FDIs and money transfers. During the years from the falling apart of the Soviet Union, Russia has been one of the least attractive in the CIS when it comes to attracting FDIs if counted per capita. At the same time, as the FDI inflow has been relatively limited, large amounts of money has been fleeing the country destined for one or the other of the world's tax-heavens. Improvements were seen, and the exodus of capital was clearly on the decline until the legal process against the country's richest man and CEO of Yukos, Khodorkovsky, was initiated in October 2003. There seems to be little doubt that not only general economic reforms will continue, but also the control over natural resources will be tightened.



Despite the economic progress in some fields, much will demand continued attention. Examples of such problematic fields where actions have been taken, but still needs continued, or even constant attention, are the social sector, housing, banking, law enforcement as well as the administrative reform spheres. Initiatives are needed to keep up the momentum in the transition to a market economy. At the same time, there is a risk in overheating in some sectors, and it seems to be approaching especially in the real estate investment market. These markets are overheated, according to Minister of Economy, Gref, and this opinion is shared by many analysts and will, according to Alexander Baranov at Russkiye Fondy, lead to that: "*The country faces an inevitable crisis in 2005-2006*" (Gazeta, 2004-02-19).

The Russian government has also started to consider a possible plan to introduce an economic amnesty that would cover violations that occurred in the late 1990s, much during the privatization process and later, incurred tax violations. The first such plan in the former Soviet Union area was introduced in Kazakhstan during early 2003, but, as the minister of Finance Kurd in concluded: "*The general public is not ready for such a step*" (Pravda, 2004-04-19). To make such a move possible, and acceptable to a majority of the population, could still take years, as Russia is a much more open society than e.g., Kazakhstan. Still, the most dramatic changes must find a reasonable degree of public support, which takes time in a country with a history of 70 years of collective ownership.

### **Economic development**

During 2004, the Russian GDP increased by 7.1% compared to 7.3% for 2003, and amounted to a total value of RUR 13 300 bn (USD 410 bn)<sup>31</sup>. Industrial output for the year increased by 6.1%, compared to 7% for 2003, with energy production having increased by 9% (9% in 2003), machine building and metal fabrication 12% (9%). Within the fuel industry, crude oil production increased 9% (11%), coal production 6% (8%), and natural gas production 5% (5%). In the machine building and metal fabrication category, growth was strong in the manufacture of railway equipment and rolling stock, which was driven by increased rail shipments of crude oil. In the ferrous metallurgy category, pipeline production was a fast growing product groups (FSSS, 2004-08-07). The problem with the growth during later years is largely that it has to some 2/3 been generated by growth of prices in the energy sector and only to some 20% by increased production (WB-Ru, 2004-04-20). During the later part of 2004, several of the most important indicators have shown slower increasing trend for growth, with industrial production being an example (Minfin, 2005-01-11). The sectors that have achieved the largest gain in productivity out of these have been the ones that have faced the strongest competition from foreign import.

The federal budget for the third year produced a surplus during 2004 of 1.5% of GDP, compared to a 1.8% during 2003, with oil and gas contributing strongly through high world market prices during the year. During the first 11 months of 2004, the surplus for that period had come to a record of 3.9% of GDP, or about 540 bn (USD 19 bn) in money terms, and a projected 1.5% for 2005 (MOEDT, 2004-12-12)<sup>32</sup>. For 2004, the assumed budget was average Ural oil price of only USD 22/bbl which has led to that record sums that have been set aside for the stabilization-fund (sometimes called the reserve-fund) established in early 2004. This fund was created in 2003 to stabilize incomes over time as a way for the government to save some of the surpluses in the state finances during years of budget surpluses, generated by high world oil prices. Transfers to the stabilization fund have been considerable, and it stood at USD 4.2 bn at the end of March 2004 and was previously expected to reach USD 9 bn by the end of the year. However, higher than expected oil prices have made the fund balloon to near 750 bn (USD 26bn) by late January 2005 when the budget surplus for 2004 had been added to the fund. Initially it was planned that when savings in the fund would reach 500 bn (app. USD 16.5 bn), it would not be extended further and surpluses will instead be included in the budget or used for special purposes. Ministers of the government have now started to voice desires about how to spend the money, e.g., education, security through the interior ministry, hydro-power, agriculture while others want to use the money to pay down foreign debt. The assets of the fund should have been placed in US, EU, or similar government debt instruments. It was not until September 30 in 2004 that Prime Minister signed the decree of investment, giving the minister of finance two months to decide about investments, which indicate that the fund had grown thus far, without any money having been invested securely (MT, 2004-10-21). The first use of the money from the fund came to be the final repayment of USD 3 bn of the USD 19 bn loans taken out from the IMF during the financial crises in October 1998 (MT, 2005-02-02). The positive economic development over the last five years has also lifted the incomes for the Russian state and during this, time it has managed to service both domestic as well as its foreign debt. On July 1, 2004 the debt totaled 4 079 bn, having dropped by 3% since the start of the year, with 3 352 bn in foreign debt (Itar-Tass, 2004-08-31). The foreign debt stood at USD 139 bn by mid-2000 and is expected to stand at about USD 115 bn by the end of 2004. Both the size of the debt and its size in relation to GDP have constantly been declining during 2004, with the ratio of state debt to GDP estimated at a modest 26%. When the budget for 2005 passed the Duma, its revenues were expected to reach 3.3 trillion (USD 114 bn) and with spendings of 3 trillion, indicating a growth of 6.3% and another year of surplus. Incomes have been based on an average oil price of USD 28/bbl for the year and the biggest increase in spendings, some 30% will be directed to defense, law enforcement and security (RosBalt, 2004-11-30).

The Russian economy, with the results for 2003 included, seems to have reached a state of stability, which has continued into 2004. For 2004, GDP grew by 7.1%, and for the first nine months, investments were up by 13%, real income grew by 14%, but inflation remained higher than what had been predicted as it ended the year at 11.7%, clearly above the 10% target (FSSS, 2004-10-10 and Vedomosti, 2005-01-31)<sup>33</sup>. In his vision for the future, the president has stated that he expects the government to see to that the Russian GDP will have doubled by 2010. To achieve this goal, a growth level from 2004 onwards of about 7.5% annually will be required (Kremlin, 2004-04-24). For 2004 and 2005, the estimations for the economic development of Russia look positive and the Ministry of Economy has predicted a GDP growth of 5.8% for 2004 and over 6% for the three coming years. The predictions about the general level of economic growth in the years to come are supported by the IMF, which predicted a 6% growth level for 2004 and above 5% for 2005 (IMF, 2004-08-21). However, GDP figures are under constant revision, with changes being announced practically monthly by different ministers and ministries, and therefore the figures can only be seen as predictions for the future.

Along with the economic restructuring that has taken place since the break-up of the Soviet Union, the importance of the different sectors in the economy has also shifted dramatically. The service sector has continuously been expanding and contributed to 60% of the economy in 2003, industry accounted for 27%, construction for 8% and agriculture for 5%. In a study presented by the World Bank in early 2004, the weight of the different sectors has been strongly questioned (WB-Ru, 2004-04-20). Seeing the importance of the oil and gas sector for the Russian economy, this sectors' importance in GDP must be much larger. The World Bank argues that many oil companies sell their crude to middlemen, in the form of trading companies, well below market value. These companies are better positioned to profit from tax relieves and as a result of this internal trading, less value is also given to the extraction industry when calculating the GDP. According to the World Bank, it would be more correct to set the share of the industrial sectors' importance in the GDP to 52 – 55% for the year 2000 (the year studied), instead of the 32% accredited to industry for the year (FSSS, 2004-08-12). It is not only in the GDP where energy companies may account for about 25% of the GDP, but they also weigh in heavily in the stock market where they have accounted for about 2/3 of total stock value. Led by a very positive year in 2003 for the oil companies, the dividends paid to shareholders for 2003 by the listed companies on the stock exchange became the highest ever, reaching USD 6.5 bn (Kommersant, 2004-09-18). Also in this field, the trend points to a strong economic development as in 1998 dividends reached USD 300 million, passing USD 3 bn in 2001 and USD 4.5 bn in 2002.

Russian leaders have come to understand that the 21st century will be economic to its nature. Energy will continue to be one of the most important playing chips in the game, making Russia an important future player. Putin, in his December 2003 speech to the nation, strongly stressed the importance that will be put on the economic development:

*"Our biggest threat is falling behind in the economic field. There is a tough, competitive battle going on in the world. But unlike previously, this battle has moved from the realm of military conflict to economic competition."*  
(President Putin, 2003-12-12, Reuters)

Over the last few years central control over the Russian energy complex has become much more authoritarian, at the same time as actions by the state monopolies for pipeline transport, Transneft, and for gas, Gazprom, has received strong state support. Generally it is seldom so, with the possible exception of Norway, that states with a strong energy dependence has been especially successful in building democratic governing systems and following up on human rights. A large dependence of energy from Russia could also open the way for political extortion by way of energy supplies on Asian consumers, in the same way as has been happening on the European side. A factor that possible partners in Asia must be thoroughly considering before going into large-scale agreements for energy supplies from reservoirs in Siberia.

Russia's economic recovery, in the last five years, have much taken place despite the economic situation in the surrounding world has been problematic, if not depressed. Russia remains strongly dependent on the outside world with its economic prospects dependent on oil prices, a falling dollar value has also depressed savings in Russia. Connecting the two in a way not seen before, where changes that take place in the capitalistic world have an immediate effect also in Russia. Especially so as much of the Russian raw material exports see it prices negotiated in dollars, while much of the import has to be paid for in appreciated euros.

Several international as well as Russian surveys have concluded that problems like undivided authority, bureaucracy, and petty tyranny are the main obstacles for an effective collaboration with western partners<sup>34</sup>. So far there has been no real creative partnership established between the state and companies where the state delivers the appropriate policies while enterprising structures understand that they must both learn to follow this and to face competition. There are also the more general problems with Russian company structures related to management, as for example companies' internal decision-making process

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should be attended to. Public educational institutions like schools, institutes, and universities have also suffered severely in the transition process. These have generally not been able to keep up the level of teaching, little regulated forms of semi-privatizations have been seen, with money having increasingly come in to play to cover tuition fees and to secure exams and diplomas. As a result: *“the poor have been excluded and the needs of the labor market has not been met”* (The Nation Address, Kremlin, 2004 05-26). Just inside education, the money spent on corruption is estimated to have reached near USD 1 bn, with the most prestigious exam certificate in the country, from the Moscow State Institute of International Relations (MGIMO) being *“priced”* at USD 14,500 (TVCentr, 2004-10-04). This process has been going on for many years now, at the same time as low wages have led to that many workers with special skills in the educational sector, in demand from the private companies, have found new jobs. As a result, the quality of education has become very uneven among institutions, and generally less successful than in other countries in preparing students for *“real world”* situations. The combat of this kind of corruption by the FSB has made some progress, having launched 900 criminal cases during the first nine months of 2004 just inside education (Itar-Tass, 2004-10-26). However, the fight against corruption seems to be an uphill battle, as 65% of surveyed people believed that it is impossible to stamp out, with about 1/3 agreeing to that the country as a whole is corrupt (VICOM, 2005-01-12).

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Also public and corporate research, previously often conducted at independent research institutes and only to a limited extent connected to universities, has been suffering badly during the transition period. Generally, public investments in R&D have fallen dramatically. Russian investments are seldom seen to be directed towards anything that in other NEA countries would be considered as high-tech. During 2004, the government took a new initiative in this field and initiated the privatization of research institutes. A reform plan that by the Academy of Science and by the former Minister of Science has been labeled as *“planned destruction of research”* (Kommersant, 2004-09-09). The proposal was said to have been tailored in line with the indications from the president in reformulating the status of the Academy of Science, that has been relatively independent, but state-funded institution.

Although the democratization process in Russia has been ongoing for over ten years, and has in certain respect been very successful, it has, in relation to voters' participation in elections, a lot left to be desired. A similar tendency can be seen in process of forming the basics of a civic society that has generally been positive, but where reforms in many oblasts have been brought to practically a standstill since years. One of the reforms that has been carried through, and that effectively has made this writing possible, is the introduction of websites at all

Russian ministries and agencies. After the December 2003 elections to the Duma and the March 2004 re-election of President Putin, the political system has become increasingly streamlined to deliver on presidential decisions. The need to have constitutional amendments ratified with a 2/3 majority in the Duma and a 3/4 majority in the Federation Council is no more a restriction to the ruling President. A good example of the new situation was the process of approval of the highly controversial law on converting tens of millions of citizens' in kind benefits to money payments in July 2004. This was probably the most protested law by common people in modern Russian history. Still, it took only days for its three readings in the Duma and for the approval in the Federation Council. In the form the bill was signed into law by the president, it will, from 2005, give the some groups monthly cash compensation, instead of e.g. free medicine and transport. Such examples are handicapped veterans 1 550 (USD 53), World War II veterans 1 050, and handicapped citizens 950-350 depending on their classification (3 different), plus individuals with social-welfare benefits that will receive a "social package" of 450 (RIA-Novosti & Itar-Tass, 2004-08-30). In all there is a considerable reduction in support to what is already the poorest strata of the populations. However, before the introduction of the reform and first payments, a protest movement took to the streets. In just a few weeks of January, mainly pensioners managed to exert enough pressure on both federal and regional governments to reinstate a part of the benefits and to promise raises in pensions. Still, with the 1.6 million state and regional employees were unaffected by the reform.

That was followed by a declaration from the president that for his second term, he was to focus on improving the general standard of living in Russia in the coming years. The achievements in previous years can be looked upon from different points of departure. The Minister of Economy Gref has declared that the number of Russians living on incomes under minimum of survival has fallen from near 34 million in 2003 to about 29 million by the end of September 2004; still making up near 19% of the population (RJ, 2004-12-02)<sup>36</sup>. At the same time, the gap between poor and rich has increased over the last few years and by the end of H1 2004, the poorer 20% of the population received 5% of incomes while the richest 20% receive 46% of incomes. The ratio between the two groups came to 8.6 for the period compared to 8.4 the year before, with comparable figures for Europe and the US at 6 and 9, respectively (RFE, 2004-08-05). Other such wide ranging public statements given by the president have been to improve the business climate, raising the efficiency of the public administration at the same time as costs should be reduced and corruption slashed.

In the 2004 Global Competitiveness Report, when it come to costs incurred by corrupt officials, only four countries out of 104 were given a ranking lower than Russia by business leaders (World Economic Forum, 2004-10-13). Transparency International gives Russia the same miserable ranking when it comes to corruption, giving Russia a score of 2.6, with the likes of Finland and Sweden at 9.7 on a ten-point scale, setting Russia between Nepal and Tanzania. During the eight years that Russia has been included in the ranking, the value has constantly been 2.3 – 2.6, indicating that the new Putin campaign against corruption from 2004 has quite some work to do (Transparency, 2004-10-20). The National Anti-Corruption Committee has stated that more than USD 40 billion is circulating in the form of bribes and dirty money in Russia, with half of this connected to the Customs Service, the most corrupt branch of the Russian Government (Kommersant, 2004-10-27). The prosecutor-general has stated that corruption is out of control with 39 000 alleged violations registered during 2004 and with 7 000 of these investigated during the year (Itar-TASS, 2005-01-26). A survey conducted by the World Bank has, perhaps surprisingly, assessed Russia along with 145 other countries and placed it as no. 45, based on how laws are formulated, i.e., not how these laws are being implemented. Russia shared its position in the second best of five categories with both positive and negative surprises like Armenia and Georgia, on the positive side, and Estonia, as the largest negative surprise (WB, 2004-09-09).

Despite all the positive progress in macroeconomics, not very much has changed outside the centre on the micro level. Small-scale projects like supplying collective farms and small villages with electricity and making local roads useable throughout the year have continued to be largely ignored. Agricultural output has changed little as the large farms continue to dominate for e.g. grain with 85% of the harvest, while the private dachas (gardening lots) continue to supply some 90% of the potatoes consumed and 80% of vegetables. After many years of strong economic growth, the benefits for many are sometimes hard to see. Much equipment is not being replaced, much of the infrastructure continues to disintegrate and for a large share of the population, the purchasing power remains minimal. After five years of continuous economic growth, the Russian population is still not fully convinced that this is a lasting state and remains on the outlook for, and is still preparing for, the next crises.

Economically Russia is still a relatively small country and can best be compared to a just over middle income developed country in Europe. Out of its 140 million inhabitants only some 10% has a purchasing power that would be middle class in Europe, although the richest Russians would be considered as very rich in any country of the world. Despite the low average level of living costs in Russia, the country is catching up worryingly rapidly and especially so in the economic

centers. The two biggest cities, Moscow and St. Petersburg, have become the third most and 12th most expensive cities in the world for a foreigner to live in (MercerHR, 2004-06-15). It is difficult to see the future might of Russia in the field of economy, although it is still a member of the G8, a group that is supposed to be the world's biggest economies, but Russia remains a member more from tradition and for its raw material might<sup>37</sup>.

### **Taxation**

For a country emerging out of socialism, the restructuring and reformation of the tax system become crucial as the previous "*all inclusive*" system has ceased to exist. Under socialism, at least theoretically, few individuals and companies have an interest and possibility for that matter, to make any serious efforts to avoid taxes, because few personal profits are there to be gained. In a market system, the company and/or individual that can avoid paying tax will often profit from this in the form of increased personal wealth. From the states, point of view, massive reforms in society are needed during a transitional period and with reforms and other improvements that falls on the state to undertake comes a price tag. Incomes for the state are needed to pay not only for the reforms, but also the running of the state, and for a state these incomes are first of all generated through taxes. Taxes are also an ever-ongoing arbitrage between fairness for the income groups that are to pay and setting the level at an optimum. That is setting the level high enough to generate the tax income needed, but still not too high making the supposed taxpayer put too much of an effort into avoiding paying.

Tax reform has been one of the long-term projects for all Russian governments and also now there has been ongoing work on amending the law. The aim has not only been, to clarify how and when taxes are levied, but also to lower the overall tax burden. It has also been so that with continued high oil and raw material prices, later amendments has had the intention to shift the tax burden from individuals and the value-added industries to the extracting industry.

Examples of later reforms are the flat income tax, set at 13%, and the reduction of the profit tax from 35% to 24%. However, continued reforms have been discussed, with income tax would be change into something like a progressive tax system, but with a direction of reform that has seen public opposition from the president. In April 2004, the Government approved a cut in social taxes from 36% to 26%, with the intention that more companies would openly declare the incomes of their employees and at the same time leave room for the use of this money inside the companies. It is expected that the reform will lower the tax rate on wages for companies from 29% to 24%. The change will be introduced from 2005 and it is hoped to encourage companies to participate in charity or social



project of their own choice. Aiming at something like an American sponsor system, but only after first having paid their taxes in full. One problem is this line of reasoning from the authorities is that the main priority for business is to earn money for its owners, including paying taxes, but only after that, is up to the owners to use their income from the business undertaking to their own liking.

The distribution of tax incomes is a sensitive issue both from the point of view of who should be given control of its use and how much, but also which categories of citizens that will profit. In the latest amendment to the tax code the revenues from the company 24% income tax has been set at 6.5% federal and 17.5 regional, eliminating the local level budgets are receivers (Kremlin, 2004-07-30). However, the value added tax (VAT) remains the most important of the taxes, generating about one-third of revenues that, together with excise duties, these have remained federal. The total tax revenues have reached 4.5 trillion (USD 160 bn), up by 24% over 2003 (Minfin, 2005-01-20). For the oblasts, the most important taxes are the corporate property tax, gambling, and transportation taxes.

Taxation on the Russian oil export has been an important source of revenue for the state in later years and in an attempt to adjust taxation along with world market prices, duties are revised every second month. As a result, duties have risen considerably and with the level from August 2004, the new maximum rate will be 65% instead the previous 40%. The lowest level has now been set at 35%, and applicable when oil prices are in the range of USD 15 – 20/bbl. From 2005, the general mineral extraction tax (MET), also on oil that is being consumed domestically, will be raised by 15%. In line with the legislation, the duty from October 2004 will be set at USD 88/ton, up from USD 70/ton (Interfax, 2004-09-15).

The abovementioned increase on the tax on company dividends to 9% was done as a result of an increase in transfers to owners, as a result of higher profits. The second reason was because companies have been using the hitherto low level of 6% as a way to pay indirect wages to owners, i.e., paying a lower tax rather than the 13% income tax. Also, the VAT could be reduced further, having already been reduced to 18% from the beginning of 2004. Also a simplification of the handling of the VAT is under consideration, according to Deputy Prime Minister Zhukov. Tax on advance payments, VAT returns on exports and a general simplification of the tax administration will be addressed in the near future (RJ, 2004-09-30). At least the latest remark was set exactly in line with the findings of the Global Competitiveness Report that pointed to the vague and complex tax laws, second only to corruption, as the greatest obstacle to business in Russia (World Economic Forum, 2004-10-13).

A positive effect of the Yukos case, seen from the authorities, point of view, has been that the general level of taxes paid by companies is said to have increased in the aftermath of the affair (RFE, 2004-09-09)<sup>38</sup>. In the latter part of the year other oil companies have also seen similar tax demands as Yukos faced, but then nothing near the USD 13 bn claimed against Yukos. After the completion of the tax audit against TNK-BP it was presented a claim of, what in this case is a relatively modest sum, 100 million for 2001, USD 700 million against Sibneft, while Slavneft, Rosneft and Tatneft are all seeing tax audits of their operations (MT, 2004-11-12). It has not only been the oil sector that has been handed down tax claims for back taxes. In December 2004 the second biggest mobile telephone operator, VypelCom, received a claim from 2001 of 4.4 bn (USD 155 million). On the day, the value of the company fell by 20% (or over USD 2 bn) at the stock exchange, and total share value on the exchange fell by over 10% (over USD 10 bn) in two days (MT, 2004-12-10). Swings in share values of this magnitude are easy to foresee and open the possibility of highly profitable insider trading in shares for people possessing the right kind of information.

Large tax incomes are needed, because since Putin took office at the beginning of 2000, the number of state employees, "*apparatchiki*", has doubled, from 660 000 to 1.25 millions by the end of 2003. That is contrary to the reduction that was promised by the then newly instated president. The figure includes officials in state and oblast governments, but not army, law enforcement, and emergency personnel, employed at an estimated cost of about USD 3 bn/year (Guardian, 2004-02-18). One of the major ideas behind the reforms in early 2004 was that the number of employees at departments and in central federal government bodies should be greatly reduced. This would leave room for considerable pay increases for those remaining under the budget. In the process, it is critical that these reductions are to be decided by the government, taking into account the needs in various bodies. When forcing through the much-criticized reform of the benefits in kind in the late summer of 2004, the only major change to the original proposal during the process was to let over 2 million state-related employees keep their in-kind benefits (RFE, 2004-08-30)<sup>39</sup>.

### **Investments**

The share of fixed investments in relation to GDP has hovered around 16 – 17 % in recent years. Seen in contrast with the large needs in the Russian society this is a small figure and can be compared to the same figure in the EU that has been over 20% during the same time period. The needs are endless as the average age of equipment in Russian industry by early 2004 was 21 years. Over the average is machinery in electrical power, metallurgical, and chemical industries. The most modern equipment can be found in wood processing and the food industry, where the average age of machinery and equipment was 12 years (BOFIT, 2004-02-12).

The public sector share of investments, i.e., investments made by local, regional, and state authorities, has been on a slow decline but remains very important, and accounted for no less than 25% of the total during 2003. At the same time, an increasing share of private investments had reached 44%, with mixed state and private investments accounting for an additional 18%. Joint ventures and foreign companies have seen their shares remain around 11% and 3%, respectively over the last five years.

In 2003, investments in the fuel sector accounted for 22% of Russian investments, most of it going to crude extractions and oil refining. Second largest investment sector was transportation, accounting for 18% of investments, but here, a very large share was also related to the oil sector. The two dominating sub-sectors in transport were pipeline construction, oil terminals and rail (tank) wagons, where the production of wagons increased by near 100% during Q1 2004 (BOFIT, 2004-03-24). During 2004, indicators tell a story about stagnating investments inside the oil sector, with the telecom sector having increased the fastest (Bofit, 2004-10-15). Also, in other sectors the locomotive is the oil sector that demands service and equipment indirectly lifting other shares further. During H1 2004, foreign investments in Russia totaled USD 19 bn, up near 50% compared to 2003, with FDI reaching USD 3.4 bn, up by 35% (FSSS, 2004-08-19)<sup>40</sup>. Over the last two years, much of the inflow has been directed to expanding or upgrading existing installations and less so to new companies (Bofit, 2004-40). Despite not having attracted the volumes of investments as other transition economies, Russia still has over 7 000 foreign-owned large or medium-sized companies generating about 3.5% of overall employment, and over 10% of industrial production.

FDI figures look very different indeed depending on source as the Ministry of Finance reported a USD 7 bn figure for 2003 while the worlds leading authority in this field, UNCTAD reported, USD 1 bn (MOEDT, 2004-05-10, UNCTAD – World Development Report, 2004-09-16). As mentioned in the introduction, it is a tricky field to record FDI flows and just some few deals can make a large difference to the total. Unarguably, Russia has attracted the by far lowest share of FDI of all the 15 former Soviet republics, and other transition economies, with a per capita inflow of just USD 52, to be compared to the same figure for Kazakhstan and Azerbaijan of USD 938 and USD 625 respectively. The FDI level in Russia has, over the last five years been in the range of 1 – 2% of GDP while in the smaller economies, e.g. the Baltic state, the same figure has instead been near 10% (Bofit, 2004-45). To a considerable extent, this can be explained by the fact that Russia has completely failed to set up production-sharing agreements that has been seen as attractive by foreign investors in the oil and mineral sectors. In the reorganization of the government that followed the presidential election in 2004, it is now the ministry of Industry, where the former ministry of energy is

now a department, which will be responsible for production-sharing agreements. To further facilitate investments in mineral extraction, energy as well as others resources, a new law on “*subsurface mineral resources*” has been passed during August 2004 (Duma, 2004-10-24). It now gives the federal level unrestricted authority to grant permissions to extract, having taken away the “*two-key-principle*” by which local authorities could veto extraction, believed to have been frequently used as a means of extortion against companies on the local level. If that was the negative side of the old law, the negative side of the new is that it gives no say to local residents. Extraction rights will also in the future be auctioned, but the provisions for this will be clearly regulated (Kommersant, 2004-08-06). The importance of the question is shown by the fact that Russia holds 50% of the world's diamonds, 30% of the natural gas, 25% of the nickel, near 20% of the tin, and near 10% of the oil reserves (ITAR-TASS, 2004-11-11). At the same time, the Minister of Natural Resources has voiced worries of an upcoming depletion of resources as not enough prospecting is being done. As a result, current oil and copper findings could be running out by 2015 (ibid.).

Foreign investors are also scared from many sectors in Russia that per-se includes long term investments. The main problem for any investor is whether he is willing to take on the new risks for an extended period of time. Few of the international financial institutions, like the WB or the EBRD, have made investments with a horizon of ten years or longer. Already ten years is a long time and forces investors to be absolutely confident that there are no legal risks, and additionally that investments made will be protected by the government (Raiffeisenbank 2004-06-15). In the wake of the Khodorkovsky/Yukos affair, officials have, on numerous occasions, hinted that the decisions made ten years ago related to, e.g., privatization, tax breaks, and production sharing agreements could be revised (for a description of the process see below). Suggestions sure to give any possible long term investor the chills when discussing future plans and especially so when the government in early 2004 withdrew the development rights for the Sakhalin-3 oil exploration project from the initial winners of the tender, Exxon, Chevron, and Rosneft (see also under Petroleum and Sakhalin). This again served as a reminder to the business community that they are constantly exposed to government interference.

Over the years, since the start of economic reforms, Russia has continuously privatized assets in the form of companies previously owned by the state. At times this has been highly controversial and has been the base for the wealth creation for many of what today are the richest in the country. In the listing of what is currently the largest private companies in Russia, several of the very biggest were created in the loan for shares deal, while increasingly frequently,

large companies are being built in retail, real estate, and service. The biggest private company is the oil major TNK-BP (with a turnover of USD 12 bn), followed by the aluminum company Rusal (USD 4.5 bn) with the steel company Yevrazholding at third (USD 2.9) (by Forbes Russia in MT, 2004-11-01). Privatization sales have indeed contributed with large sums to the state over the years, but it has typically been a few large and more spectacular sales, most often to abroad, that has brought in the largest sums (Bofit, 2004-34). The privatization plan for 2004 includes the selling out of over 2 200 (1 300 in 2005) fully owned enterprises and over 1 900 (600 in 2005) stakes in companies. The continued process is getting increasingly difficult as the list of available assets is getting shorter and not all administrative layers are really interested in privatization as it means losing both control and revenues. The largest individual assets up for sale during 2004 are stakes in the Svyazinvest telephone company, which never took place. The largest deal during 2004 was the 7.6% state share in Russia's largest oil company, LUKoil, which in September brought in USD 1.9 bn, from US ConocoPhillips. The second largest was the 18% state share in the Magnitogorsk (MMK) steel company, which was sold to a company owned by the management for USD 800 million in December. During 2004, a list of strategically important companies, which will not be privatized, has also been circulated. It includes no less than 514 wholly owned state institutions and 549 joint-stock companies (MOEDT, 2004-09-09). A listing where many defense, transport, energy, and mineral extraction related companies have been included. It has later been indicated, that this does not exclude these companies from privatization, but if so, it must first be agreed with the president.

In contrast to most other countries the Russian banking sectors share in the financing of investments that has remained very small since the 1998 crises. During 2003, banks supplied around 5% of the capital used for investments, while the companies themselves, out of their own pockets, supplied 55% of the invested funds. An alternative source has instead become loans from abroad and Russian companies, with the stock of loans being estimated to USD 119 bn to domestic banks and USD 50 bn to foreign banks (Bofit, 2004-10-15). In the long run these are alarming figures, as it will restrict the diversification of an economy, which is already alarmingly over dependent on the energy sector. Diversification is something of a key to not only maintain the growth level demanded to first fulfill the president's desire of doubling the GDP by 2010, but also to broaden the economy.

During the years of the 21st century, Russia has relatively successfully managed to make offshore funds return. Some of the biggest flows come from banking centers of the world where not many questions are asked, with few restrictive regulations as well as practically no tax on assets. FDIs from Cyprus,

Switzerland, Virgin Islands and Luxemburg together make up more than 30% of the total inflow to Russia over the 1994 – 2003 period. The biggest investors over the period are Germany, Cyprus, UK, and the US (RFE, 2004-09-01). During 2003, the most important investors were UK, Germany, Cyprus, and France, investing from 4.6 to 3.7 bn each, followed Luxemburg, Netherlands, Virgin Islands, the US, Switzerland and Japan as the countries investing above USD 1 bn during the year. Also, China has, over the last two years emerged as an important investor in Russia, with investments of near USD 1 bn for 2004 and with plans for a manifold increase in the near future (CW, 2004-09-18).

Capital outflows during 2003 amounted to USD 2.3 – USD 7 bn (depending on source), which, no matter the source, was clearly up on the previous year. Net capital outflow from Russia during 2004 could exceed USD12 bn according to the Economic Development and Trade Ministry, while private financial institutions set the level at approximately USD 17 bn (MOEDT, 2004-09-14)<sup>41</sup>. The most commonly quoted reasons for the increase is the new intensity in the Yukos process, the mini-banking crisis in August and the terrorist attacks, e.g. in Beslan. During the first nine months of 2004, Russian firms invested about USD 25 bn abroad, with the bulk going to practically the same countries as are the origins of inbound FDIs: US, Cyprus, UK, Netherlands, and the Virgin Islands as the most important (FSSS, 2004-12-01). This outflow is said to include a dimension of tax optimization by larger companies to set aside money, that is later, to some extent, are to be reinvested in the Russian market. However, many of the larger Russian companies that have emerged after the restructuring of the economy have by now adapted global strategies, with the intention of becoming true global competitors in their segments. The necessity for international growth is explained here by the fact that if they do not go into international territory to learn from competitors, other global players will come and outdo them in their local market. Examples of such Russian global expansion could be companies like Severstal, which has taken over ailing US Michigan-based steelmaker Rouge Industries in a USD 286 million deal. Later to be followed by Norilsk Nickel, which in late March 2004 made the biggest Russian foreign acquisition, so far, in a USD 1.2 billion purchase of a 20% share in the South African gold mining company, Gold Fields.

As briefly mentioned above, in October 2003, the CEO of the second largest Russian oil company Yukos, Khodorkovsky, was arrested in his private jet in Krasnoyarsk and has since been jailed. At the time Khodorkovsky was estimated to control assets in the range of USD 12 bn. He was seen as the leading figure of the group of the so-called Russian “*oligarchs*”, group that saw much of their wealth originating from the controversial “*loans for shares deal*” in 1996. This was a deal that served as a basis for the creation of this relatively small but highly

influential, group of newly rich entrepreneurs with holdings valued above USD 1 bn. A listing that can be considerably extended, if made to include people with assets spread in different lines of business the number of people with holdings above USD 100 millions will include well over 100 (Vedomosti 2004-04-15)<sup>42</sup>. In the evaluation made by the World Bank's Moscow office the share of the country's GDP produced by Russia's 23 biggest companies, controlled by just 37 individuals, was estimated to be 30% of the national GDP (World Bank 2003)<sup>43</sup>. Of these 37, only 15 appear on the listing made by Forbes Magazine over the richest Russians, indicating the difficulties in estimating wealth. However, these 37, and many many more, have undoubtedly become very rich, by any standards, during the years of economic transition in Russia. On average, these control about 80% of shares in their companies, which is a higher level of ownership than for other controlling owners in similar kinds of companies. Ownership often stands around 70% for companies owned by the state or foreign investors. Later research has shown that the transparency in companies regarding the ownership of privately owned shares in the companies, is generally very low. Seen in contrast to the shares owned by other companies or institutional investors, shares in larger Russian companies to an additional value of USD 114 bn are owned by individuals, but without the true owner being disclosed (Forbes, 2004-10-12).

The most frequent view on oligarchs among ordinary Russians is that they have unfairly seized assets. From another point of view, it could be argued that these assets have made their owners strong enough to resist any attempts from the state to re-nationalize. During a time when the future path of the country, towards a market economy, was put in doubt, these holding have forced through a restructuring in many sectors. In this way, having been active in creating a more competitive private sector, and as a result increasing the value of these companies. Still, it is necessary that the authorities continue to take drastic measures to enhance competition in many sectors that have remained near monopolies. Measures that probably will have to include the breaking-up of several of the oligarch's large conglomerates<sup>44</sup>. Several possible explanations to the jailing of the Yukos director Khodorkovsky has been presented from different sources, and if a true answer exists, it could well be a combination of these. The problem is seen by some as he did not only promote liberal politics (in the run-up to the Duma elections in 2003), but also promoted the building of a privately owned export pipeline, towards Murmansk, and had initiated the process of merging the two oil majors Yukos and Sibneft. In a next step, it has been widely assumed, the new company created by the merger would partly have been sold out to one of the US giants, with Exxon Mobile as the likely buyer. Creating a position where he would have become "*untouchable*" for the government (MT, Polit.RU, RJ, various issues).

The process that has been surrounding the Yukos oil company, following the numerous tax claims for back taxes from 2000 – 2002, totaling over USD 27 bn, finally led to the sale of its major production unit, Yuganskneftegas on December 19, 2004. Auctioned off in Moscow, between two bidders it was taken over by the previously unknown Baikal Finance Group, registered in the minor city of Tver, for USD 9.4 bn. Only three days later, on December 22, Russian state-owned oil company Rosneft announced that it has bought the Baikal Finance Group giving it control of over 77% percent of Yugansk. Rosneft is about to be merged with state-controlled gas monopoly Gazprom during 2005 and has presidential aide Igor Sechin as its head. The whole process surrounding the handling of Yukos can do a considerable damage to the image of Kremlin (if not so already) as it is becoming increasingly obvious that the handling has been coordinated from the top level. It is probably unheard of in the world that unknown people, for unknown purposes, with money of unknown origin, is allowed to acquire another company, by some said to be worth USD 20 bn (with control of over 10% of the national oil production). Comments by the president to the auction of Zugansk were, *“in compliance with the Russian law”*, and to the Rosneft takeover deal *“perfectly normal”*. Critiques have focused on the collection of the claims for back-taxes were only an excuse to only indirectly transfer assets back under state control (MT, Polit.ru, RJ, Vedomosti, 2004-12-17 - - 12-28). These deals have effectively wiped out the Khodorkovsky / Yukos oil empire and the reply has been a legal battle over the sale that was initiated before the sales, setting Yukos under bankruptcy in a US court (Huston, Texas). According to US legislation, this would have meant freezing assets of the company, which was ignored by the Russian authorities when the auction of Yugansk went ahead as planned. The Yukos side has said that it will battle the decision in court and that Rosneft, through the deal, *“is taking on a serious headache”* (Interfax, 2004-12-22). The result of future court decision could well be that foreign Russian assets, belonging both Rosneft, its future owner Gazprom, or eventually also the state, will be frozen as Yukos is asking for USD 20 bn in compensation. With unhappy Yukos shareholders in a number of western countries, the court battle could come to both spread to other countries and drag on for years to come (Vedomosti, 2004-12-26). Information that has become public later indicates that the Rosneft take over of the Baikal Finance Group was partly financed by USD 6 bn of Chinese funds made available to Vneshtorgbank that granted the loan to Rosneft (CW, 2005-02-02). For the remaining parts of Yukos, the problems continued after the sale of Yugansk, as a new claim for large back-taxes were filed at its remaining large production unit, Samaraneftgaz, of near 30 bn (Kommersant, 2005-01-26).



### **Banking and monetary policies**

According to the CBR's statistics for 2003, the Russian current-account surplus for the year was USD 36 bn, up from USD 29 bn in 2002, which corresponded to about 8% of the Russian GDP for the year. The surplus was generated by a surplus in goods export that grew to USD 60 bn, while the services balance was in deficit by USD 11 bn, of which a large share of which has its origin in a rapidly increasing Russian tourism abroad (CBR, 2004-04-14). Net errors and omissions items in the balance of payments reached USD 7 bn, more or less on level with 2002, which partly relates to (illegal) foreign currency exports. During 2004, the trend was a large outflow in the first three quarters of the year that reached USD 18 bn. This later turned into a strong inflow during Q4, which came to reduce the full year outflow to about USD 8 bn. During the year the previously large outflow of unrecorded capital largely ceased, which had, until then, somewhat offset foreign currency earnings that was registered as a current-account surplus. Low interest rates in the West also made large banks and business, that had achieved creditworthiness, to borrow and bring home cheap money. As a result, the Russian currency reserve increased by USD 26 bn, or near 40%, during 2003 to stand USD 87 bn by the end the year, to continue on a slow increase to USD 124 bn by the end of 2004. Private capital outflow has increased during 2004, partly off-setting the increasing incomes from oil revenues (Bloomberg, 2004-08-25 + 09-17, CBR, 2005-01-28).

A relatively new tendency is the appreciation of the Ruble relative to the USD, which came to +19% in real terms in 2003 (RIA, 2004-04-08). Something that has continued during 2004 when the Ruble reached a four-year high, surprisingly without any CBR attempts to support the Ruble. However, when the 28 Ruble to the USD barrier was broken in early December, the Central Bank again started to buy dollars to reduce the value (RJ, 2004-12-03). Already prior to this, the Russian Ruble has been revaluated by nearly 5% during the first half of 2004 against a basket of its main trading partners, by over 5% again the USD and by over 6% against the Euro. The effect to this is that, e.g., the Russian manufacturing industry that has seen a strong revival since the currency crash in August 1998, again see its competitiveness being eroded by a rising value of the Ruble. An increase in purchasing power of the Ruble makes foreign products cheaper for domestic consumers.

CBR has, for a long time, been expected to change the anchor of the Ruble from the USD to a basket of based mainly on the Euro and the USD. The balance of the currency in the CBR's reserve is normally in proportion to the trade relations of a country and the Euro share has only been 10% while trade with the Euro area has been about 50%. Inflationary pressure is rising in Russia with the long-standing high oil price and mounting inflows of currency at the same time as

given credits from domestic banks have risen sharply. The governments' target for inflation during 2004 was set to 10% and missed by near 2%, and in the 2005 budget draft, the target was set at 7.5 - 8.5%, but with a CPI, that during January 2005 alone increased by over 2%; that target is difficult to make creditable (Bloomberg, 2004-08-22). It becomes a very difficult balance, if not impossible, to avoid inflation in an economy where there is a large inflow due to the strong export, both foreign loans and domestic credits are increasing and on top of that, FDIs are increasing. Seen from these factors, the outflow of capital, legal or illegal, could be seen as positive as it is in the current situation reduces the inflation pressure. To slow down inflation, the CBR could let the value of the Ruble rise by more than the 7% that has been stated, which would have a positive effect of not only increasing purchasing power, but also increasing imports. By 2006, if plans are not to be postponed again, the Russian currency is intended to come into circulation also on the money market of Belarus as a future union partner (Bofit, 2004-37). The Belarus economy is small, about 5% the size of the Russia, but there are also a number of political obstacles that must first be solved before a merger can be carried through.

For 2003 Russia attracted foreign capital inflows to a value of USD 29.7 bn, which was up over 50% on 2002, but with foreign loans making up USD 22.2 of that figure. FDIs were also up, near 70%, to USD 6.8 bn, while portfolio investments were down by 15% to USD 401 millions. The income balance deficit of USD 13 bn for 2003 was largely generated by foreign investors' interest and dividends. Net outflow of capital for the year was about USD 2bn. The net outflow of FDIs was USD 3 bn and portfolio investments USD 5 bn. Total inflow came to USD 19 bn, giving a net inflow to Russia for the year of USD 6 bn from other investments, but mainly from borrowing abroad. Russian companies receiving export incomes in foreign currencies have, during transition years been forced to convert incomes to rubles. The share that must be exchanged has gradually been lowered and in its latest step was reduced from 25% in November to 10%, and to be eliminated from 2007 (Bofit, 2004-49).

Saving in general has been seen as a problem in Russia with a major shift having taken place in the capital market over the last few years, as an ever larger share of total savings are being kept in Ruble. Another shift has been the demand for US dollars, which has decreased at the same time as demand for Euros have increased. In late 2002, the value in the exchange market of the Euro surpassed the value of the Dollar when measured in Rubles, which only strengthened its attractiveness. The Euro will not replace the US Dollar, but only serve as an alternative. People once proud of having dollar-based salaries, while the Ruble was unstable, have instead ended up on the losing side during later years. Still a short hiccup in this trend was seen during the mini-banking crises in 2004.

Much of the Rubles that were withdrawn from accounts, were again largely converted to US dollars/currency, which came to recreate a brief “*dollarization*” trend that lasted during a month of the summer.

Russia has, since the breaking up of the union seen the creation of near 1 300 mostly very small, banks. Still, the Russian bank sector is small and the combined common assets of all banks are not much larger than a mid-size international European bank. This large number of smaller banks makes the system difficult to fully control and when the Sodbusinessbank had its banking license withheld in mid May, a shiver was felt throughout the banking system. Two months later, during just two days, July 8 and 9, depositors withdraw USD 859 in savings, from first of all two banks rumored insecure, Gota Bank and Alfa Bank, and USD 2 bn above normal during the month. Additional foreign currency was also withdrawn that the CBR does not give statistics for (MT and CBR, 2004-07-22 & 08-10). This, called a “*mini-crisis*” in the banking system, had a positive effect as it was shown that the challenged banks, with support from the CBR, could overcome the crisis with a combination of adjustments<sup>45</sup>. As a result of the summer crises the CBR has tried to speed up the work on a deposit insurance system among smaller bank. Customers in Russia’s two outstanding largest banks, state-owned Sberbank and Vnestorgbank already enjoys this deposit guarantee for assets up to 100 000 Rubles per individual (USD 3 500). During the mini-crisis, Sberbank logically received billions of Rubles of new deposits <sup>46</sup>. In all, as of July 6, there were 1 183 applications from banks and credit institution to join the deposits insurance system (Aton, 2004-07-16). Later in the year, the CBR has decided to cancel the license of a smaller number of banks, but has also added another 80 banks to the list of banks enjoying credit guarantee (CBR, 2004-10-27). Despite the instability, there is foreign interest to invest in the financial sector. One such merger was made in July 2004, when BNP Paribas, France’s no. 2 bank, became majority owner in the credit card/auto lending group Russky Standart Group, making it the largest financial take-over in Russia (Vedomosti, 2004-07-17). Further on, it became public that the International Moscow Bank (IMB) will become the first bank of size in Russia that will see a foreign majority ownership. Germany’s second largest bank, HVB Group, is to raise its stake in the bank from 43% to 53%. In the share offering made by IMB, which will more than triple its capital base to USD 320 million, Scandinavian Nordea bank will also hold 26%, with BCEN-Eurobank and EBRD controlling the remaining portion (Bloomberg, 2004-09-27).

### **Employment**

The “*economically active*” population in Russia has been estimated at 73 million of the total population (RIA-Novosti, 2004-08-19). Out of these, the number of employable should be about 72 million, which sets the latter group to fewer than

50% of the population, a figure that is expected to remain stable for the coming three years (MOEDT, 2004-08-16). At the end of August 2004, Russia had 5.4 million unemployed setting the unemployment figure to 7%, which is about 600 000, fewer than at the same time one year before, with about 30% of these having registered as officially unemployed (Kommersant, 2004-09-22).

Wages in Russia during 2003 increased by an impressive 25% in nominal terms, and that rate has been maintained during the first nine months of 2004. The average monthly wage in Russia by the end of September 2004 was just under 7 000/month (USD 240) with industrial workers earning about 8 500 and average pension at 2 000. (Bofit, 2004-45). Oil extraction had the highest wages at near 25 000/month, 350% above average, followed by gas extraction at 300% above. Coal and ferrous metallurgy were just 45% above, while the lowest wages were paid in retail sale, health care and education, with the latter being paid about 5 000/month, setting wages at about 60 – 70% of the average. Still, as much as about 20% of companies' wage bills are estimated to remain unaccounted for, at the same time as about 25% household incomes fall inside this category. Although, the survey data for 2000 – 2003 indicate that this share is slowly falling (Bofit, 2004-11-11).

During the first eight months of 2004, real incomes rose by 9%, which was apparently largely being consumed as retail turnover rose by 11% for the same period (MOEDT, 2004-09-20). One important result is that the importance of private consumption in the GDP is increasing, and has reached beyond 40%. The continuation of these income improvements will be important to make it possible to double the GDP, envisaged by the President, as it should dramatically reduce the number of people living on incomes under the poverty line. Currently near 30% of families live on incomes under the domestic poverty line of USD 70/month, with the figure from the World Bank setting the figure at about 20%<sup>47</sup>. The regional differences are considerable as the average salary in Moscow is given as 13 000 (USD 460), but still with educational and social workers earning less than half of that (Vedomosti, 2005-01-17). The government has furthermore decided to raise the Russian minimum monthly wage, more used as an index base than as an actual wage payment level, by 20% from 1 January 2005 to 720 (USD 25). At the same time, the average monthly basic pension will rise by 12 % to 2,467, and so will wages for all state employees (Prime-TASS, 2004-08-23).

However, the Putin plan to double the Russian GDP by 2010, that would require a yearly growth of 7.1% could look well on track, with the strong support by world oil prices during 2004. Perhaps even more so at the adjusted date, 2014, later set by the government (RFE, 2004-08-03). The minister of Economy, Gref,

has forecasted that by 2015 the per capita GDP should have reached USD 18 000 (Minfin, 2005-01-13). Still it must be doubted if the growth power in the economy can be generated without considerable privatisations and restructuring inside the oil and gas, transport, large state monopolies and oligarchs' holdings. Additionally to this more general skepticism, not particularly innovative and voiced by many, the IMF has doubted that a sufficiently strong political will exists for this (IMF, 2004-06-28). Adjustments to the prognoses by the Ministry of Economy for the near future growth to 6.3% during 2005, 6.1% in 2006 and a slight rise to 6.5% for 2007 support such skepticism. Russia is still considered to be a "transition economy", but with a persistently positive economic development, it could be time, within a few years, to omit the use of the word "transition" when talking about the Russian economy.

### **2.1.2. Russia - EU relations**

The European geographical direction has historically been the most important for Russia and has remained so also during the years of transition. It is from here that three military invasions have come, but it is also in this direction that a large share of both former times and today's Russian foreign trade has both its destination and its origin. The share held by the EU has constantly been on the increase, as a result of the gradual geographical expansion of the EU during transition years, with several Russian neighbors joining the organization. In 1995 Sweden, Finland and Austria were added to the members' list, and then ten more countries in 2004. Several countries that joined in 2004 had previously been members of the economic and military cooperation, being practically subordinate to the Soviet Union (COMECON and Warsaw Pact). As a consequence of the emergence of this expanding economic space, the importance of EU as both a political-, economic- and trade-partner to Russia has increased considerably<sup>48</sup>.

Over the first years of the 2000s the relation between Russia and the EU has been ever improving was anticipated to retain the tension that the inclusion of the central Europe group of EU members would give rise to. Instead, toughness from both sides, not seen for a long time, re-emerged in the negotiations, sending cold chills in the direction of the days when the old dividing line between east and west was so clear in Europe. Although nothing like a break in the relations between the two is, or was, at hand the two have established strong links as Europe depends on Russian oil and gas. At the same time, Russia, on May 1 2004, when the expansion took effect, lost a number of favorable trade and travel arrangements with the new EU members. That questions with no formal connection suddenly become inter-linked is probably a normal strategy

in diplomatic work. For the Russian side, opposition to a new Partnership and Co-operation Agreement (PCA) while the expansion took effect, replacing the one from 1997, was one of few issues that could be used to show opposition. That so many different issues were brought up in the negotiations is what is worrying here, as this indicates some kind of structural weakness in the interaction between the EU and Russia. A structural problem, or perhaps more precisely procedural, that should be dealt with jointly, not to undermine co-operation and to avoid the emergence of similar situations in the future. That could mean a new negotiation mechanism, but then it should be of a different kind that does tackle issues before nearly becoming "*fait accompli*", like in this case. Russian EU policies have for so long, both inside and outside Russia, been criticized for not having been sufficiently co-coordinated among ministries and the presidential administration. This could be expected to change and to become more stringent in the future. Especially so seen to Prime Minister (since April 2004) Fradkov background as Russian representative in Brussels, he will most certainly have a clear opinion on what will have to be done (EU-Ru, 2004-06-12). For the time being, and for the foreseeable future, it is likely to be so that it is better for Russia to be engaged with the West than to be outside and isolated. The West should also keep its faith in Russia, even if all the expectations for the establishment of a full fledged democracy in Russia appears to be over for now. Hopefully, it is so that the two neighbours have come to a stage of their mutual relation where a higher degree of openness to debate could be accepted without causing any lasting harm to the relation.

One of the reasons behind the problems that arose along with the EU eastward expansion was the fact that many of the new EU members were important Russian trade partners. Russia saw that the continued free access for its export to these markets is important. The EU position, on the other hand, was that Russia, with no exceptions, should extend all the current EU-Russian agreements to the new members. One such example has been the EU quotas for the import of grain from Russia. Prior to expansion, Russia exported grain to all former Eastern European countries without any restrictions, while now these countries are subject to obey the regulations in the EU Common Agricultural Policy (CAP). It was stated from the Russian side that the losses that will occur as a result of the EU enlargement, under EU conditions, would amount to EUR 150 m annually. This was seen as an economic loss large enough to strain diplomatic relations for a considerable number of months. Russian demanded compensation, included terms like asking for visa-free travel to Europe for Russians, financial aid to the Kaliningrad region, lower customs tariffs, and higher quotas for the import of Russian goods. In a step of conciliation, EU officials have indicated a readiness to open separate talks on some issues.

The EU, on its side, used the situation around the acceptance of new members to increase the pressure on Russia. The EU not only demanded that Russia should delimit its borders with Estonia and Lithuania, but also wanted to see reforms in the energy sector, raised security standards in the sphere of transport and nuclear energy and a stop to the charging of unfair fees for airlines using Russian airspace.

The new PCA includes reductions of the overall tariff on Russian goods exported to the EU, which, based on the new agreement, will fall from 9% to 4%. The EU also agreed to increase steel quotas by 437 000 tons, in addition to the current quota of 1.3 million tons of flat and long steel products, that can be imported to the 15 old member states (Bloomberg, 2004-03-21). Metals continued to be a problem area as Russia wanted larger quotas and Brussels accused Moscow for having restricted the supply of scrap, being the world's leading supplier, by way of imposing an export penalty. Indirectly the action should have been taken to protect domestic producers in Russia, as more scrap is needed in steel processes in Europe<sup>49</sup>. When signing the new agreement with Russia, the EU did not impose any restrictions for its import of energy, neither in the form of oil and oil products, nor in the form of gas and electricity. The two has also negotiated about Russia's entry into the WTO, where Russia, later in the year, accepted the EU demand of raising domestic gas prices for industrial users by something like 40% by 2006 and a doubling by 2010. In return, EU became the first of its major trade partner to accept an agreement to support the Russian entry.

On the ratification of the Kyoto Protocol that was one of the most important EU demands, the Russian position has been ambivalent, as the Duma was not prepared to ratify the protocol. The president first indicated in the early summer of 2004 that Russia is moving in the direction of ratifying, but statements by ministers of the government on occasions supported and sometimes strongly opposed any ratification. To come into force, the Kyoto Protocol had to be ratified by no fewer than 55 countries, accounting for at least 55 percent of global emissions in 1990. With Russia emissions corresponding to 17% of the total, its acceptance tipped the balance. After the United States had rejected the treaty that minimum could only be reached with a Russian ratification. The treaty is controversial because of the high cost of implementation has to be carried by the developed nations that participated. Russian supporters say that the treaty, which allows countries to trade greenhouse gas emission allowances, would provide an opportunity to attract international investment to improve the energy efficiency and competitiveness of the nation's crumbling industries (UNFCCC, 2004-08-24). The Russian argument against ratification is often that other countries that have signed the protocol have not undertaken enough

restrictions and these are countries with strong economies and relatively large emissions. The Russian's fear that they will become too restricted for the future if they go along with the regulations of the protocol. Finally the government on September 29 2004 decided to endorse the Kyoto Accord, as it was noted by Deputy Foreign Minister Yuri Fedotov, "*The fate of the Kyoto Protocol depends on Russia. If we rejected ratification, we would be the ones to blame*" (Itar-Tass, 2004-09-29). The Protocol was clearly approved by the Duma and the Federation Council; with support of the pro presidential party United Russia against the opposition by the Liberal Democratic Party, the Communist Party, and Rodina. With the signing of the president on November 5, 2004, Russian documents are delivered to the United Nations, to make the treaty go into effect within 90 days. The target set for Russia is equivalent to the 1990 level, but due to the economic collapse of much of the former heavy industry, emission levels are currently some 30% below the 1990 level (Kremlin, 2004-10-26). Emission quotas that can be sold on to other countries in need, to a market value where these 30% are hoped to bring in somewhere between USD 15 – 40 bn.

Despite many optimistic statements about the positive development of EU-Russian friendship and strategic partnerships, relations between Moscow and Brussels came to be badly strained by the complicated issues surrounding the EU's eastward expansion. The positive sign is that the relations were good enough to absorb all the strain that the extension caused. Although the solutions to some of the problems proved hard to find, it was all settled at the negotiations table without going into any trade conflicts. Consequently, it was expected that at the summit held in November 2004, an agreement about deepening of partnership relations could be reached, but this was postponed and is instead expected to be signed at the next meeting in Moscow in May 2005 (FT, 2004-11-26). That the meeting was held parallel to the "*orange revolution*" demonstrations over the elections in the Ukraine, where the two parties supported different sides, did not smoothen the matter. That Russia came to accept both the raising of gas prices and decided to ratify the Kyoto Protocol after pressure from the EU, although later, have restored some of the previous damage done.

### **2.1.3. Russian Far East**

The Russian advance to the east started early, and more than 350 years ago, already in 1638, the first outposts on the Pacific coastline was established. Making Russia into a country with a Pacific coastline already some 200 years before the US and 150 years before Australia was even established.



This distant part, from Moscow's perspective, has always seen its remoteness being emphasized also in its name. Being not only distant from the national centre, but it is also unfriendly climatically to human inhabitants and therefore sparsely populated. It covers a surface of 6.2 million km<sup>2</sup> (two times India) and has also internally large distances between population centers, having over its 350 years, remained an economic burden for the country as a whole. The possibility for any real internal control from the centre did not arrive until the extension of the Trans Siberian Railway reached the Pacific in 1905 (on only Russian territory from 1915). At the same time as improved communications facilitate central control, it also facilitates contacts in-between subunits and the outside world. All countries have internal differences between regions and generally the bigger the country the more different the regions. That is also the case in Russia and these are circumstances that at times could increase the risk for internal tension. A constantly strong military presence in the Far East has never left it in doubt that Moscow has always intended to keep the control over the area, no matter the costs. As mentioned above, the region has been of strong military interest with e.g. Vladivostok becoming an open city as recently as 1991, from having been a military port closed to foreign visitors. To make it possible to hold a population also in the Far East, transports were subsidized, and today's citizens have to pay some 100% more than the average for Russia in only transport costs. Needed investments have long been avoided, as the Trans-Siberian railway was not fully electric until the last 500 km stretch, in the Primorsky Krai south of Khabarovsk, which was completed in 2002.

The Far East was not a region that was favored as a place to move for ordinary people during Soviet years. Therefore, work here was often related to higher wages and advantages that were to compensate for the inconvenience. A system that slowly died out with the falling apart of the Soviet Union, and has left the Far East sliding down on the scale of well being among Russian regions. Generally, the Russian Far East is today worse off than the average Siberian and Central Russian regions in practically all indicators that measure social and economic standards. The Far East in 1986 had 7.6 million inhabitants, to be compared to the current level of 6.6 million. The past ten years has seen clearly higher mortality than nativity figures at the same time as a large share of the workforce has moved west. The region is still losing much of its young professionals who see better prospects in other regions, with 60% of the younger generation considering to move west (vladnews, 2003-11-05). The years from 1990 to approximately 1999 were marked as the years of deepest crises in the region, while the years since has seen a relative recovery, based on energy production. The Far East in 2003 held less than 5% of the national population and produced about 6% of the national GDP (FEBRAS, 2004-07-02). The population on this gigantic area currently corresponds to one bigger Chinese city, or 15% of the bordering Heilongjiang Province, that holds about 40 million.

The criminalization surrounding the use and control of marine resources over the entire transition period has fed criminal structures in especially the economically important Primorsky Krai. The near chaotic governor election in Primorsky Krai in late 2003, won by Sergei Darkin, that despite all strange episodes was approved from Moscow could indicate that the central control is not as strong as anticipated. The same situation has for years surrounded all local elections of a new mayor and a local Duma in the gateway town to the east, Vladivostok, being the only really well known city in the Far East. The local elections of July 18, 2004, that made Vladimir Nikolaev mayor of the city, despite his criminal record, were similarly controversial<sup>50</sup>. Perhaps surprisingly, Nikolaev has, during his time in office, proven highly efficient. With good connections to the governor of the region he has, e.g., been able to reinitiate the work at that local Duma that had long been at a standstill due to a boycott from the opposition, and again made water and electricity freely available in the city (RRR, 2004-10-10).

Foreign trade in the FE was to a large degree concentrated to its three NEA neighbours in 2003 with China being the destination for 35% of exports and origin of 25% of imports, with the corresponding figures for Japan being 20% and 24% and in the case of Korea, 15% and 17%, respectively (Ecrin, 2004-10-01). Quoting the presidential envoy to the Far Eastern Federal District, Pulikovskii, industrial production in the Far East grew by 8% during H1 2004 (RosBalt, 2004-08-03). In the region, Russians are the largest investors with Japan as the leading foreign investor with Korea being ahead of the US and China. With the oil projects on the island of Sakhalin being the by far largest of any projects in the Far East, buy-ins from any country are bound to lift investments from that country to the top of the ranking. If, e.g., the intentions discussed between Yakutia's biggest company Alrosa and Sumitomo of Japan, for the possible development of both coal and oil resources, this would probably be large enough to make Japan stay on top of the investment ranking for several years to come. The only major project has been a 10 km<sup>2</sup> cross-border free trade zone that will be created in the city of Suifenhe in Heilongjiang, and Pogranichny in Primorski Krai. Here, an estimated USD 1 bn will not only be invested in creating a trade-zone within four years, with general trading facilities, but also to cater for tourism and entertainment. In perspective, the building of a high-tech manufacturing park is being suggested (CBW, 2004-06-15).

During 2003, 1.4 million Russians visited China while only half as many Chinese visited Russia, or about 660 000. From the presented statistics, it can be estimated that the number of Chinese workers in Russia could be in the range of 150 000 to 200 000. A figure that can be compared to the 35 000 was the figure estimated by the Russian national census during 2002 (Statistics from the Chinese embassy and polit.ru, 2004-03-31).

In the talks about regional reorganization in Russia, it has been discussed if it would be optional to create something like three or four units inside the Far East. If so, Sakhalin and Kamtjatka could be expected to form a future region, the coastal oblasts a second with the inland oblasts forming a third. It could, from an economist point of view be argued that large parts of the Far East area, as well as many other parts of Siberia, should be left uninhabited to form larger and more productive centers. That is if the population should not even be made to move into western parts of the country instead, which would probably be even better from a macro economic perspective. The five main population centers of the Far East, made up from the seven Oblasts east of the Lake of Baikal, are Khabarovsk, Vladivostok, Yushny Sakhalinsk, Petropavlovsk-Kamchatky and Chita (see map).

## **2.2. Trade**

The Russian trade surplus for 2003 was near USD 60 bn, compared to the 2002 surplus of USD 46 bn. Russia's foreign trade rose by 25% during 2003 to 6.5 trillion (USD 211 bn). Exports increased by 26% during 2003 to a total value of 4.2 trillion (USD 135 bn), while imports rose by 24% to 2.3 trillion (USD 75 bn). Out of this, the share held by the CIS countries in exports accounted to about 14% while the share reached near 23% on the import side. For the first eight months of 2004 trade expanded by about 25% to USD 166 bn and year total are estimated to reach about USD 230 – 240 bn. The trade surplus have reached near USD 85 bn after ten months of the year and still looks sure to increase further and could well surpass 100 bn (MOEDT, 2004-11-10)<sup>51</sup>. Trade with the CIS came to USD 31 bn and other countries to USD 138 bn, with the CIS trade expanding most rapidly of the two, by 36% and 22% respectively. Since 1998, the year before the large increases in oil prices started, Russian export has nearly tripled, up from USD 74 bn while imports have doubled from the official figure of USD 60 for the year<sup>52</sup>. During later years, the import figures have been rising faster than the rise in domestic demand, indirectly indicating an increasing share for imported goods in the market.

During the first half of 2004, energy accounted for over 55% Russia's total exports, with oil making up some 52% of that. With high world market prices and rising production volumes, the oil sector is constantly increasing its share of the fuel and energy exports. It is also oil and oil products that are contributing the most in the increase of exports, having increased clearly faster than the average. According to Russian trade data for 2003, 68% of Russian exports were destined for Europe, 8% to the Americas, 7% to China, 2% to Japan and only 1% to South Korea while 9% goes to other Asian destinations<sup>53</sup>. That a change is

underway can be seen from the fact that the yearly increase in trade with countries in the Asian region are far from the one-digit-level and instead, growth is often in the range of 20% or more. As a further, but non binding, step in its improving its position in the Asian region, Russia, in late 2004, became the seventh non-member to sign the basic ASEAN, Treaty of Amity and Cooperation in Southeast Asia, with the aim of increasing its cooperation with this group of South East Asian countries (RFE, 2004-12-01).

Some 35% of Russian exports used to go to EU 15 and by the establishment of the EU 25 the share has reach just under 50% by the end of 2004, giving the broadened EU a controlling stake in Russia's foreign trade. For 2003 it was two EU countries that were Russia's largest trade partners, Germany taking 10% with the Netherlands second at 7%, also showing the largest increase of the larger partners, up by 65% during the period. For the EU, Russia does not have a similar importance as it is only the fifth-biggest trading partner for the union, with trade between the two worth near USD 100 bn. It is especially in the field of energy that the EU and Russia are important partners. Of the Russian oil export, 53% in 2003 was destined for the EU, representing 15 – 20% of EU oil consumption. Over 60% of Russian natural gas exports goes to the EU, making up 25% of total EU, natural gas consumption, as 25% of the enriched uranium. With the expansion of the EU, the geopolitical situation in Europe changed dramatically and the new EU 25 is important as a *“power centre in the system of multipolar international relations”*, according to the Russian Foreign Minister, Lavrov (RFE, 2004-12-28).

As understood, the trade pattern of Russia is very similar to that of any developing country with a strong dependence on energy products and other basic raw materials; in the range of 75% of the total. At the same time, these commodities have seen major price fluctuations over later years on international commodity markets. At the same time, foreign trade has become increasingly important for Russia with trade volumes rising from about 20% of GDP in the early 1990s to about 40% in 2003. In perspective, Russia must widen its production base of goods and services to achieve a level of sustainable economic position. In doing so, a much wider range of goods will have to be traded and these are highly likely to fall under the WTO regulatory framework. According to Minister Gref nuclear reactors are Russia's most important industrial export product, bringing in USD 800 million, jet engines USD 600 million and ships USD 560 million. According to the minister, near USD 700 million in 2004 were given in export credits, and this will rise to USD 850 million in 2005 (RIA and Itar-Tass, 2004-07-21 – 07-23). The largest credit for 2003 was USD 400 million to China for the building of a nuclear plant at Tianwan (Bofit, 2004-31).

Arms export is one sector where Russia has been very successful as an exporter over the last few years with exports reaching near USD 4 bn in value. Armament is a high tech sector, as a large share of the export success is based on advanced aircrafts, warships, submarines and other advanced equipment. Only to neighboring China the value of exports since 2000 has been estimated to nearly USD 6 bn, with basic products as oil and wood making up much of the remaining export. Chinese exports to Russia are, to a large extent, low-tech, and made up of garment and food products. Trade between the two countries have also expanded rapidly and came to near USD 16 bn during 2003 and is came to just above USD 20 bn during 2004 (CW, 2004-09-18 & 05-01-07). A complication to the trade relation was the Russian 30% import tax that was levied on all Chinese products from April 2004. This resulted in a chaotic situation where cargo that had entered Russia, but had not been declared, could not be picked up from bonded storages (MT, 2004-04-25). A situation that has eased, but that probably has added on to the unregistered trade between the two that already for 2003 was estimated at USD 6 bn.

Russian foreign trade with Japan reached about USD 5 bn in 2003, about USD 1 bn bigger than trade with Korea. Which for both neighbours must be considered to be very low figures, compared to the economic size to the two Asian nations (METI, 2004-03-20). The Russian export of energy in the form of crude and coal is not only dominant, but the export includes many other basic products, like wood, fish and basic steel. On the import side it is first of all cars, car parts, and electronics that are imported from Japan and Korea.

### **2.2.1. WTO and (free) trade agreements**

Russia applied for membership in GATT, the predecessor of what since 1995 is the WTO, already in June 1993. At the time hoping to become a member before the turn of the century. Negotiations proved slow from the beginning and the financial crises in 1998 practically brought it to a stop. After President Putin had declared WTO membership as a priority, negotiations were reactivated in late 2000. During these ten years, the Russian economy has changed considerably towards becoming a market economy, practically converting it into another country compared to the country that handed in the application in 1993. Many different dates for a possible Russian WTO entry has been set over the years, but real dates will, in the end, depend on the progress of the negotiations. It was previously hoped that negotiations should have been concluded in time for the WTO general assembly in Cancun in September 2003, but such expectations proved to be greatly overoptimistic. Negotiators have encountered numerous disagreements and despite the fact that the later stages of the negotiations have been reached, it can still take some time to conclude that final accord.

At the moment, Russia is the biggest of the world's economies that is not a member of the WTO, which enhances the interest for both parties to make Russia a member. Russia is, at the same time, a very good example of many of the advantages and disadvantages in relation to a potential member. A membership of the WTO is partly intended to become a way to gain a general and international recognition for the efforts to establish a working market economic system. It will also provide for less non-discriminatory treatment against export products, and open up for the use of the WTO's dispute settlement mechanism<sup>54</sup>. From the one side, a positive effect should be achieved through domestic quality and quantity improvements through increased competition. On the other hand, that is exactly what is being feared by many local producers, as that would put them out of business. The circles that oppose a possible membership, or demand much prolonged transition periods, often fear the increased exposure to foreign products. The Russian market still has a number of product segments and regions with severely restricted competition, which see few reasons for change and instead resist.

The problems focused upon in the Russian negotiations are, from one point of view, very similar to that of most countries. It is often agriculture subsidies and trade in agri-products that are major stumbling blocks. In the process of negotiating possible membership terms are currently another 25 countries and especially for other CIS countries the treatment of Russia will set a precedent. EU demands that Russia should raise domestic energy prices, is another question that has become an important issue to include in the discussions. Cars, airplanes, and textile products have proved to be problematic products as well. This question has been raised because EU sees below world level energy prices as an indirect subsidy to local production<sup>55</sup>. How gradual such an increase can be made in relation to world market prices is being discussed, while a price increase would indirectly lead to increased energy savings that would also benefit Russia. Still discussions have not reached questions like the possible discrimination according to WTO policies, when Russia supplies gas to CIS countries cheaper than for export outside of the CIS. Additionally, other more traditional trade issues like the customs code, levels of duties, and quotas are problem areas under discussion. The Russian promise to raise domestic prices, along with the Kyoto ratification, has so far been enough to gain EU support for a WTO membership.

Russia's chief WTO negotiator in Geneva has, since 2003, been the Deputy Minister of Economic Development and Trade, Maxim Medvedkov, until replaced along with the entire Kasyanov cabinet in March 2004. In the new ministry, Medvedkov was set to head the Trade Negotiations Department, and has, as a result, continued to be responsible of the WTO application process. Negotiations have included discussions at both bilateral and multilateral

meetings, with the WTO Working Group on the Russian WTO entry as the official negotiation forum. The Working Group set up for Russia has attracted no less than 60 participating countries, with discussions related to goods trade attracting representatives from 50 of these. Parallel to this, there are ongoing bilateral negotiations with a number of countries, where some has been concluded, such as difficult issues in the custom system, industrial subsidies, Trade Related Intellectual Property RightS (TRIPS), services, and finally agriculture<sup>56</sup>.

In March 2004, Medvedkov stated that he hoped to finish the negotiations for a Russian accession to the WTO before the end of spring 2004. A prediction based on the 2003 negotiations with ten countries had been completed and for another fifteen to twenty, the final stages of the discussions had been reached (MT, 2004-03-18). For the Working Group meeting, there are nine sections related to the third part of the working group report that were discussed: taxes, the collection of custom duties, free economic zones, and activities of state enterprises. More meetings for the multilateral working group on Russian customs code and agriculture were needed. EU leaders, at the Russia-EU summit in Rome in late 2003, expressed the intention that Russia should enter the WTO before the end of 2004 (RJ, 2004-02-26). In April 2004 though, the Minister of Economy Gref lowered the expectations and predicted the spring of 2005 as a more probable date of entry. In the second half of 2004 the most probable date of entry was put forward further by Gref to possibly 2006. Early 2006 was also voiced as a possible date for Russia to join the WTO by the EU trade commissioner, Lamy, when in Moscow (MT, 2004-09-18). After Russia had been given approval for a bilateral deal with the EU, it is now approaching one with other important nations as China, Japan, Korea, and the US.

In preparation of a possible membership 36 Russian laws have been changed or amended in the last four years, with only four remaining, to prepare laws for a WTO accession. But, according to Medvedkov, this is “*a not so perfect practice of their application*”(Interfax, 2004-07-09). Russia has long been accused to be slack on violations of intellectual property rights, which is especially being stressed by the US. Possibly as an answer to this criticism, in August 2004, came the first harsh court sentence for piracy with a 3 ½ year prison sentence for DVD copying by a court in Rostov Oblast (Interfax, 2004-08-18). If this is the beginning of a massive attack on the large-scale business of piracy, with this sentence as a precedent, remains to be seen<sup>57</sup>.

### **2.2.2. Neighbor relations**

Based on a comparison of GDP growth figures over the last few years, it is not difficult to predict that if current trends remain, there is an impending shift in Russian foreign trade that will take place during the coming ten years. The trend is clear that the "*Confucian trio*" of China, Japan, and South Korea will increase their importance to Russia considerably compared to countries in the west. This group, including other Asian nations like India, could make countries along Russia's eastern borders compete in importance with its Western neighbours in the next couple of decades. This as a result of that the economies in the east are growing more rapidly and are generally being in a phase of development that favors trade with Russia. These eastern neighbours are mostly big importers, and can be expected to become even more important importers of many of the raw and semi-processed export items that are the backbone of the Russian export (Brunswick UBS, 2004-05-25). In the upcoming situation, there is a policy conflict for the three Asian governments in China, Japan, and South Korea in expanding imports of Russian oil, gas, metals, and other resources. The stumbling block here is often the inability of Moscow to make decisions between priorities vis-à-vis the three and at the same time balance in-between the interests of domestic lobbies in Moscow. After all, it is the oligarch-owned Russian corporations that are probably the ones best positioned to take advantage of the predicted expansion of demand in these markets.

This development has also been realized at the highest level, as the statements by the President Putin at the APEC summit in Thailand in 2003 has clearly shown. He stressed here the importance of a good relations to the APEC community because it: "*gives us new unique opportunities, including for the development of Siberia and the Far East,*" adding, "*we invite everyone to mutually beneficial and efficient cooperation, including on a multilateral basis*"<sup>58</sup>. This invitation could also be seen as a way to also strengthen the internal control of the region, as these contacts will largely have to be conducted through Moscow. The process could also become supportive for Moscow in the way that the more prosperity that could be transferred, the less difficult the continued control will be.

#### **China**

Despite having diplomatic relations with China since the 1949, this could not stop the two neighbours to get involved in an armed conflict in 1969 over a few sandbank islands in the bordering Amur River. What initially was a small conflict escalated to the brink to an all-out war. The conflict with China led to that a large part of the army, perhaps as many as one million soldiers at the time, came to be stationed in the region. A peace agreement with China was later reached and in 2001 a treaty of "*neighborliness, peace and friendship*" was signed,



to follow up on a strategic partnership established in 1996. Land claims for the two bigger disputed islands, Bolshoi Ussuri and Tarabarov, found just west of Khabarovsk, were postponed<sup>59</sup>. At the time it was decided that the issue should be settled by future negotiations, which is apparently exactly what has happened. Negotiations that has kept a low profile and just after President Putin had visited China in mid-October 2004, it was made public that an agreement had been signed that had ceded the Tarabarov Island and a part of Bolshoi Island to China. In exchange, there will be an increase in economic cooperation between the two (RFE, 2004-10-21). The existing partnership between the two neighbours is aimed at covering issues related to energy, migration, and military cooperation. Relations in the region had already improved greatly before the agreement and during summer months, there has even been visa-free boat trips to the Chinese market town of Fuyuan 30 km upstream the Amur from Khabarovsk. In the latter part of 2005 the near ultimate stage of cooperation will be reached, as coordinated military exercises will be held on Chinese territory.

Russia probably fears its own weakness in the Far East as much as the strength of its southern neighbor China, with whom it shares a 4 200 km. The approximately 6.6 million Russian population in the vast Far East area is to be compared to some 100 million living in the Chinese provinces bordering Russia. In the beginning of the 1990s the national Russian economy was practically on the same level with the Chinese, but since then the two has parted completely in this respect. Today, China is a country that is economically three and a half times as powerful as Russia. Ironically, this has led to that the Chinese army has renewed its equipment, to a large extent sourced from Russia, with more modern equipment than what has been made available to the Russian army. Now, the FDIs from China directed into Russia have reached USD 1 bn for 2004, bigger than the Russian FDIs in China that has reached under USD 800 million. As a result of the Putin visit to Beijing, China also promised investments in Russia in the range of USD 8 bn for the next few years (Bofit, 2004-43). Additionally, mutual trade between the two is now about USD 20 bn, and increasing rapidly, indicating that the relation between the two neighbours is getting ever more economical and improved.

The combined effect of a decreasing population in the Far East and the difficulty for many less educated Chinese to find a job locally has given rise to labor migration between the two. The inflow of Chinese workers to Russian border regions has, first of all, been due to low paying jobs in agriculture and construction. That is of both a legal and Il legal kind, largely doing the same kind of jobs that émigrés from Central Asia do in the European parts of Russia. How many the visiting workers actually are remains a disputed question, and has been set as low as just a few percent, to as many as 15% of the population in

Primorski Krai. With a generally shrinking Russian population in the Far East, and having a country with the opposite problem across the border, fears of a slow take-over could be understandable. Despite the fact that the only real conflict between the two has been over some small island, the large expanse of the Far East could well become the centre of a struggle over influence rather than aim for its own sovereignty. The Russian and Chinese regions that share borders here are all among the least developed of regions in the two countries. For all regions and both countries it would probably pay the best dividend if the development in this extended border region could be coordinated. However, the long term Russian fear of a Chinese “take over” in some form, is not likely to fade away anytime soon and this complicates the matter. Although the general sentiment in the Far East region could be that China will sooner or later take over the region, the border is there, and Russia is likely to spare no effort to keep it in place.

### **Japan**

Already on his inaugural press conference as Russian Foreign Minister, in March 2004, Sergey Lavrov advised Japan against insisting that the disputed islands of Kurils should be included in a potential bilateral peace treaty. “*We will deal with it on the basis of the Constitution*” (Lavrov quoted in JT, 2004-03-19). Thereby reminding Japan that Russia will address its territorial preservation and integrity as it has been stipulated under the Constitution. However, efforts will be stepped up to conclude a peace treaty, as “*The relations with Japan are progressing*” (ibid.). Progress has probably been made through diplomatic channels in the meantime and with the Russian agreement with China, perhaps paving the way, a new attitude for a future compromise could slowly be emerging. By November the same minister was quoted saying “*We want to regularize our relation with Japan*” while referring to the proposed peace settlement from 1956, which was never adopted, and includes the return of only the two southernmost islands (RFE, 2004-11-16). The Japanese stand, declared by Prime Minister Koizumi, is that Japan will reject any such proposal. Moscow finds it problematic to come to terms with the Japanese position, albeit a considerable activity on the economic field is still focused on the need to resolve the territorial issue around the Kurils. On the islands, Russian seismic research has established large findings of oil, over 350 mt, a number of other minerals deposits large enough for extraction, there are rich fishing grounds inside their territorial waters, and additionally, there are over 10 000 Russians living on these islands. Despite the problems concerning the Kurils, the relation between the two has improved considerably. The Self Defense Forces became the first navy ever to visit Kamtjatka in September 2000, and has also conducted a common navy exercise with Russia in late 2003 (JDA, 2004-06-13).

## **Korea**

The relation with Korea took a leap forward with President Roh's visit to Russia in September 2004. It was then confirmed that there are currently no issues complicating the relations between the two and a declaration of "*Mutual Trust and Comprehensive Partnership*" was signed. At the same time it was decided to hold regular talks in the future (Kremlin, 2004-09-22). From an economic point of view, the two countries look very compatible with a high tech industry in a raw material-starved Korea, and the relation looks like it will develop positively. On the individual level, the interest among Russians seems to be bigger for Korea than the other way around as the flow of Russian visitors to Korea in 2003 came to 170 000, while only 40 000 Koreans came to Russia (CI, 2004-09-25).

A resolution of the **North Korean** conflict would not only solve a possible threat, although not in any form directed against Russia, but it would also open a new window of opportunities. The North Korean economy, and much of its infrastructure, has to a large extent been built by assistance from the Soviet Union. It is probably hoped that Russia will find major openings whenever it will be time to do the reconstruction work. The building of both railways, roads, and pipelines that will cross North Korean territory has long been discussed and in case of a peaceful resolution, or even reunification, large-scale construction projects can be expected to be launched relatively soon.

## **2.3. Energy**

The energy sector has been in the centre of attention for the Russian state both for its strategic interest and for its huge importance as an income generator. Since the loan-for-shares deal in 1995, most of the larger companies in the oil sector has been privatized, but with the state often holding an influential post of shares in some. During the years since the world price level increased in late 1999, by coincidence well-timed with the appearance of Putin as Prime Minister, the generated incomes has stabilized the economic development. The importance put on the energy sector is demonstrated by the fact that all major state companies in this sector can be found on the list of companies that have been excluded from privatization<sup>60</sup>. The sector could probably have been both larger and more efficient if all the energy-resource-development licenses issued by authorities over the last ten years had come into use. The number of such licenses controlled by private companies, but not yet developed, by the Ministry of Natural Resources was set to 23% out of the 16 000 that were issued (Vedomosti, 2004-09-14).

In later years, some of the state energy holdings have been sold off at a good profit, like in the biggest of the oil companies, LUKoil, while the interest in the giant gas monopoly Gazprom has been reinforced. In Gazprom, the state has instead declared its interest in increasing its 38% share to become a majority owner. In mid-September 2004, the take over by Gazprom of the largest state owned oil company, Rosneft, was announced. Being paid for Rosneft in the form of Gazprom shares, the state will, after the merger, hold the desired 50% +1 share in Gazprom (RJ, 2004-09-15). Just a month after that news, another merger of the state owned oil company, handling several large international operations, Zarubezhneft, has been included in the merger into what will be called Gazpromneft (Nestro, 2004-10-20). The future, now even larger, Gazpromneft will not only control over 20% of the world's gas reserves but also over 20% of Russian oil reserves and about 10% of production or about 35 mt. As the original Gazprom was also well inside the ten largest oil producers, considerable coordination advantages are probably to be found in the new organization<sup>61</sup>. At the same time, the company will be opening up to a much larger portion of its shares to be owned by outsiders, which is bound to leave its mark in a new and more market-minded approach to management, transparency and efficiency. All three are aspects for which the company has been receiving strong criticism from minority owners and other outsiders since it was created. Outside of fossil fuels, the Russian energy sector is a mosaic of different kinds of facilities on the gigantic landmass of the country. All over, the largest of the power generator is the United Electric System (UES), when it comes to electricity. However, the energy sector also includes a multitude of other companies that could be anything from oil companies extracting crude oil to hydropower generation, but also the extraction and burning of coal and gas.

As was discussed already in the part about the economy, the World Bank and the Russian Government have very different opinions on the importance of the oil and energy industry to the Russian economy. The reason for the underestimation of the importance of the energy industry in the country's GDP, is explained by the lack of consolidated accounts inside the large oil companies. In the oil and gas sector, larger companies have established devoted production companies responsible for the extraction of crude and gas. In its next stage, the products, still low priced at this stage, are sold to trading companies inside the same company group. These trading companies are responsible for the refining and distribution/export of the products. From this point of view, it is natural that the production companies incur high costs and low profits while the trading companies have relative low costs, but makes a considerable profit from sales. As there are a large number of these trading companies, and the trading volumes are very large indeed, this shifts the balance of the entire economy into a stronger showing for the service sector<sup>62</sup>.

The dramatic increase in Russian energy earnings from export is not only a result of increased production, but also from the fact that the energy intensity has been falling sharply. The energy consumption per capita (i.e., energy intensity) in Russia has declined during transition years. Russia had an energy consumption of 6.1 toe in 1990 that had fallen to its lowest at 4.1 in 1997, and has then slowly risen to about 4.3. Compared to other large and northern countries this level is low, as Canada had an energy intensity of 8.2 toes and the US 8.4 toe in 2000. Nordic countries, like Norway, Sweden, and Finland showed a much lower consumption than the states of North America, 5.7, 5.4 and 6.4 toe respectively, which still made them clearly more energy intensive economies than Russia. The Russian energy intensity is that of a medium income country in Europe, but much higher than countries on its own GDP per capita level, and many times higher than e.g. China, that had a consumption of only 0.9 toe per capita in 2000 (WB, 2004-08-22). One of the main problems for Russia is its critically low level of energy efficiency. Also, the Industry and Energy Ministry has understood that this must be attended to, as during 2003 average domestic energy consumption was more than twice the world average and over three times that of the EU. There is a considerable potential for savings as the ministry estimates that between 40 – 50% of energy is wasted. About a third of the wasting falls on the fuel and energy industry, while the rest is shared in-between industry, utility companies and the housing sector. (MOEDT, 2004-12-14). The Duma has called on the ministry to annually report on the progress in energy consumption and the Russian adherence to the Kyoto Protocol.

On the energy front, Russia is exploiting ways to win advantages and on the eastern front, with Japan and China having been locked into a bidding war for Siberian oil. On the western front it is Europe with its dependency on gas deliveries from Gazprom and as a consumer of over half the oil export. In the south, among the CIS states, both Gazprom and UES are extending their ownership into the energy systems of neighboring countries. Such examples are large UES holdings in Georgia, Armenia, and Kazakhstan. UES has also shouldered the responsibility to finish the building of two large hydroelectric dams, initiated by the Soviet Union in the early 1980's, in Kyrgyzstan that will come in production by 2007 (Kommersant, 2004-08-20). At the same time Gazprom has secured large interests in gas distribution and pipelines in Belarus, Ukraine and Lithuania.

Under the demand conditions of 2003 and 2004, coupled with a world oil price well above most expectations, and with clear tendencies of economic recovery in much of the developed world, global oil consumption and prices could be expected to stay high. From high world market prices, Russia benefit substantially already, and benefit even more from planned increases in output.

Russia has already reached a somewhat pivotal role in the global energy market, having stayed outside to the OPEC group of countries. In the near future it could become the power broker that can tip the balance between OPEC and the United States. In the years of the Soviet Union, it was the 14 000 nuclear missiles that were giving political weight, while in the future this weight could instead well be conducted by where Russia will allow its energy to be consumed.

### **2.3.1. Petroleum**

The production of oil in the former Soviet Union started in the region around Baku, in what today is Azerbaijan. Already before WW II the focus of production had started to move towards the North East and the Southern Urals, but came to continue to move further to the North East into western Siberia. Today it is the Khanty-Mansi Autonomous Okrug, located around at the junction of the two rivers Ob and Irtysh, which is the Russian centre of production. Soviet time production reached its peak in 1987 with 570 mt, with nearly 90% being produced inside what today is the Russian Federation. Production then started to decline and Russian production reached a low of just over 300 mt in 1996. After the disintegration of the Soviet Union the oil export has become increasingly important with some 50 – 60% of Russian oil production being exported. In the long term planning, it has been foreseen that the Russia's annual production should increase from its 2003 level of 420 mt to approximately 500 mt by 2010, or about 6% per year. A major factor restricting the Russian production growth is market access, it is for this reason that the access to existing pipelines, and the building of new ones becomes so important. Although there are hundreds of companies producing and refining oil in Russia, the domination of a handful of companies is considerable. In 2003, the ten largest oil companies produced some 90% of the crude and together owned about 80% of available refining capacity.

Russian crude oil output reached 458 mt during 2004, up 9% from 420 mt in 2003, which was up 11% from 2002, with about half the production exported (Transneft, 2005-01-16). According to the energy ministry's August forecast, Russia will produce 6–8 % more crude oil during 2004 than in 2003, a figure 2-3% lower than what industry sources estimate. With the current rate of increase in production, Russia will be more or less at par with Saudi Arabia as the world's biggest producer. During the January - September period 2004, Russia's oil output increased by just fewer than 10% to 341 mt, surpassing previous expectations, indicating a full year production of about 450 mt (FSSS, 2004-10-02). Russian oil output growth is likely to slow in years to come, after having risen by more than 50 percent since 1999 until the end of 2004. Also outside

factors like the higher taxation and insecurities generated by the Yukos case will contribute to this. Among the companies, Yukos was the biggest producer during 2004 with 86 mt (64 mt for 2003) followed by LUKoil with 86 mt (62), TNK-BP with 70 mt (37), Surgutneftegaz with 59 mt (44), and with Sibneft being fifth in size producing 36 mt (31). The export share among these companies during H1 was between the 34% of Surgutneftegaz to the 47% level of TNK-BP (Aton, 2004-08-02).

Exports of crude oil in 2003 reached 225 mt, up 12 % from 2002, slightly more than the increase in production. Oil exports during the first nine months of 2004 rose by 14% to near 160 mt, which was a sharp increase as the figures were adjusted upwards by over 10% in October (Customs RU, 2004-11-23). Full year export shipments, according to Transneft's planning, are to increase during the latter part of 2004 to reach a level of near 230 mt (Transneft, 2004-10-12). The urge to export is generated not only by the fact that there is a considerable difference in prices between the domestic market and foreign markets, but also from the fact that domestic oil consumption is expected to stay relatively flat in the near future. Of the crude export during 2003, 83% was exported to non-CIS countries at an average price of just under USD 25/bbl, as calculated from the customs statistics. For exports to CIS countries, the average price paid was significantly lower, around USD18/bbl (Reuters, 2004-09-14). During just the first six months of 2004 a total of USD 25 bn in revenues from export sales had been transferred to the foreign currency accounts of Russian oil companies. Being over 30% more than for the same period in 2003, with an average June 2004 price declared for export crude of USD 30/bbl, 20% higher than for the same month last year. When discussing oil prices, it must be remembered that the price for Ural's crude is quoted at about USD 2.5 – 3 lower than world quotation for North Sea Brent oil, which in turn is lower than Texas Intermediate<sup>63</sup>. Attempts to sell Urals via international exchanges have so far been futile despite the large difference in production volume where 9 mbd of Urals stand against the 400 000 Brent produced (Interfax, 2004-02-28).

As shown by the production statistics the largest Russian oil companies when measured in production volume for 2004 were Yukos, LUKoil, TNK-BP, Surgutneftegas, Rosneft and Sibneft. This has since changed and the state has again become a major owner in the industry. Initially the state sold out a controlling majority in the oil companies to private investors in the loans for shares deal in 1995, but long kept a considerable share in the largest oil company, LUKoil. The state share of 7.6% in LUKoil was auctioned in September 2004, for just under USD 2 bn to US ConocoPhillips (LUKoil, 2004-09-18). Two months before the auction, the ConocoPhillips CEO met with Putin and after the deal, the company continued to increase its holding to above 10%, and has revealed its intention to raise its share to over 20%, which would also secure a

post on the board. Probably as a statement of “*no risk*” before this sale, and to show that it will not become a new Yukos case, LUKoil publicly declared its tax payments for H1 2004. The company had paid USD 3.4 billion, up by 24% due to increased extraction levies, which would correspond to over 4% of federal revenues for the period. This was from an oil output that rose by nearly 9% in the period to 42 mt (Reuters and LUKoil, 2004-09-09). The largest foreign investment in the oil sector, to date, is the 50% takeover by BP of the third largest oil producer TNK in 2003, at an announced value of over USD 6 bn. A company that together with Sibneft is a 50 - 50% owner each of the seventh largest oil company Slavneft. In its takeover deal with TNK, BP has included a paragraph that will make its share in the deal immune against future state claims; like what happened to Yukos. The large production volumes and what is still relatively low production costs, in combination with high world market prices, has converted the Russian oil sector into a highly profitable business. During 2003, the total revenue for the sector reached USD 70 bn, with USD 38 bn of that earned from exports, leaving a net profit of USD 25 bn, after having paid the same amount in different taxes (RJ, 2004-05-19). Profits during 2004 have probably been kept at least the same level, as world oil prices have risen further and with domestic prices having gone up by some 80% during the year.

In March 2004, the Russian Economic Development and Trade Minister, German Gref, stated that 2004 would be the last year of major export growth, as exports will surge about 14% during the year to 266 mt. In the following years, growth will be minimal, or around 2 % per year for several years to come. Although the industry indicates continued expansion, the research of IEA presented in its World Energy Outlook indicates the same slow growth trend as Minister Gref, by forecasting the year 2030 production level at 540 mty (IEA, 2004-10-26). Also investment figures support a slowdown in the sector as shown in the first nine months of the year when the aggregate had fallen by near 20% compared to the year before. With the increasing insecurity in this line of business along with the development in the Yukos case, and ever-larger tax intakes out of possible profits, all these have taken a toll on long-term investments (Ria-Novosti, 2004-12-01). Not to over-tax the oil industry Minister Gref has mentioned the possibility of some reductions coming into force during 2005. Since 1995, Russia has been increasing its exports every year, while OPEC has, at times, been doing the opposite, where the main argument in later years has been the need to compensate, by higher oil prices, the effects of a depreciated dollar. If the prediction by Minister Gref will be converted into policy, it could indicate a policy that is moving it closer to the policies of OPEC, and indirectly, the Arab world. OPEC is at the same time an organization that is likely to come under increasing pressure over the next few years, as instability in the Middle East continues and some members, such as Venezuela and Nigeria, have been under strong pressure to break its ties with OPEC.

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To make numerous Russian reserves in eastern Siberia, offshore Sakhalin and eastern Arctic come on stream in the future will take major foreign involvement. It is not unreasonable to expect that many potential investors can be found among energy and raw material-hungry neighbours in NEA. So far, Russian oil companies have concentrated on discoveries in the western Siberia basin and been exporting the output to Europe. Further to the east, Russia can afford to meet both neighbours' demands for energy and raw material and at the same time help them to diversify supply away from the Middle East. To make this possible, Moscow could allow the construction of pipelines by private investors to the Asian markets, i.e., China and Japan. The law on Production Sharing Agreements (PSAs) has been updated as late as during 2003, with some controversial deals have been signed, e.g., for some of the Sakhalin projects. Here foreign oil companies have been allowed to take over the task of raising capital and developing new fields in the region, something that could be followed elsewhere in the country as well as in related sectors.

A final word of caution should also be included when it comes to oil and gas as the estimations that are presented by the companies could be compared to what happened with reserve figures by the international oil major, Shell, in 2003. Figures published by the company as "*proven oil and gas reserves*" showed to be overstated by as much as 20%, leading a number of lawsuits against the company, falling share prices and a forced resignation of the CEO. Also, the National Resource Ministry in Russia has been made aware of this problem and will, with the help of the FSB, start to monitor reserves and production volumes reported by oil companies (RFE, 2004-08-13). A surprise fully in line with the Shell revision mentioned above, but on the reverse, appeared only one month later. The most important production company inside the Yukos group, Yuganskneftegaz, that control 60% of deposits, declared that its reserve were five times larger than what had been stated previously, up by 1 bn ton (Kommersant, 2004-09-18). Declarations by Sibneft that it has made the largest finding in Russia in the last 15 years, in its Vankor field in the Krasnoyarsky Krai that could produce 15 mty, should perhaps be looked upon from this "*Shell*" perspective (Bloomberg, 2004-10-17). It is not only on the company level that oil figures are insecure, but also as experts are complaining that the whole OPEC group is exaggerating its output volumes. The reason for boosting, to get higher internal production quotas, could add-up to as much as 7.5% of total production for the group (Groppelong, 2004-08-07). If so, the exaggeration would correspond to approximately the production volume of Yukos.

### **Transport of petroleum**

The most important component in the transport system for crude and oil products in Russia today is the pipeline network. Parallel, and all through the history of Russian oil extraction, large volumes of crude and oil products have been shipped by railway over long distances.

During the years of transition, the pipeline network has remained a monopoly under the control of its fully state owned operator, Transneft. The pipeline system for transport of crude and oil products has a total length of about 47 000 km. A network that came to see its first expansion phase in the late 1950 and its second, with the international pipelines build to countries in Eastern Europe, in the 1960s and 1970s. Before the building of these large export pipelines to “*brotherhood nations*” in the former Eastern Europe, deliveries were upheld by a huge operation by way of rail shipments. As the importance of findings in western Siberia increased, the network also expanded eastward, and later on to the North East. It was not until the late 1990s that the building of new lines took off again with the building of the Baltic Pipeline System and continued expansion to connect new production areas in Siberia and Timan-Pechora. The only major pipeline on the territory of the Russian Federation that is not under full control of Transneft is the CPC line, connecting the gigantic Tengiz field in NW Kazakhstan with the Russian oil terminal in Novorossiysk. This line, although largely laid on Russian soil, is operated by a consortium lead by the field’s operator Chevron Texaco, but includes both the Russian state and several Russian oil companies among its owners.

The volumes transported through the pipeline network, which is separated for crude oil and oil products, were about 310 mt of crude and 25 mt of refined products in 2003. In Transneft’s plans for 2004, crude exports will increase by about 15 %, or nearly 30 mt, to 230 mt, with the total transport volume in the system to reach some 460 mt (Reuters and Transneft, 2004-09-14). In the current situation, the capacity in the pipeline system is one of the serious factors that limit the expansion of exports. Alternatively, that spare capacity do exist but in parts of the network where production has been falling. At the same time, the building of new lines is becoming increasingly expensive in line with the rapidly rising steel prices. With Transneft having received constant criticism from many sources during 2004 for being the limiting factor in the Russian oil export, its CEO, somewhat surprisingly, was quoted to have said that “*there is spare capacity in the system the oil companies have not been able to fill*” (MT, 2004-10-17). As often, the situation is impossible for an outsider to assess, and the truth is probably to be found somewhere in between these opinions. At the same time, oil companies have constantly increased their own direct export by rail or by way of inland shipping and especially the number of oil rail tank wagons in use has been

increasing dramatically over the last few years. Today, an increasing volumes of crude and oil products are being railed from production areas to both refineries and export terminals. Still about 80% of exports flow through the Transneft pipeline network, or about 600 000 tons per day, at a price of about 10 – 12 Ruble per 100 km. This price will follow inflation and increase by 11% in 2005 (Bloomberg, 2004-12-08).

Apart from the mentioned pipelines in Europe and other CIS states, most of the Russian oil export is seaborne, although being loaded after having transited to ports in Estonia, Latvia, and the Ukraine. The biggest Russian export outlet for oil is the terminal in Novorossiysk where a volume in the range of 40 – 50 mty has been loaded for export in later years. Also in the Black Sea is the smaller export terminal at Tuapse that already in 1928 was the first in the Soviet Union connected with a pipeline. Still much of the increase in the export from Russia in later years has been loaded for export at terminals like the new Baltic Sea terminal in Primorsk, some 150 km west of St Petersburg, on the northern shore of the Gulf of Finland. The terminal here, opened in late 2000, has seen unprecedented expansion, and was, by the end of 2004 handling at a rate of 50 mty. Another terminal is under construction at Primorsk and will be connected by an additional 1 050 km pipeline along the route of the previous, Primorsk-Kirishi-Yaroslavl, and then on to Kstovo. Transneft will invest 80% of the USD 870 million needed to ship about 8.5 mty initially, and with 25 mty as its designed capacity (Transneft, 2004-10-08). Only 20 km beyond Primorsk, on the eastern shore of the Gulf of Vyborg, is the next large export terminal being built by LUKoil. The terminal here is to handle exports of 5 mt of oil products from 2005, but relying on rail deliveries, something that has already proven problematic. The expansion of the terminal is constantly ongoing and it will have the capacity to handle 100 000 dwt tankers from 2005, and with capacity to be extended to 12 mty by 2007 (LUKoil, 2004-12-24). Transneft has suggested to the government that they would be better suited to handle both this terminal and a somewhat larger terminal under construction by Surgutneftegaz in Batareinaya Bay, on the south shore of the Gulf of Finland. Neither of the two oil companies has shown any appreciation for this “offer” from the state monopoly (RJ, 2004-06-02). In the near future there will also be a number of smaller new devoted terminals built in the Russian North West at Murmansk, Vitino, Severodvinsk, Vrandey and Indiga. In late 2002, a number of Russian oil companies presented grand plans of building their own large-scale oil pipelines, from fields in Western Siberian to Murmansk on the coast of the Barents Sea. To date, it has always been state pipeline operator Transneft that has been behind the building of oil transport capacity in Russia. Initially, the Murmansk pipeline was to be built jointly by several of the major oil companies. At a time when the feasibility study of the Murmansk project had barely been initiated, the

authorities crackdown on Yukos/Khodorkovsky, one of the largest participants in the project, commenced. As a result doubts followed about Yukos attempted merger with another of the project participants, Sibneft (which later had to be reversed). As a result of this, the prospects for the first major private pipeline dimmed considerably, although it is still wanted by the oil companies. The idea behind the Murmansk pipeline was the prospects of a sharp rise in exports to the US, and that the location of Murmansk would be convenient as a year-around ice-free access to the Atlantic. The project idea has been taken over by Transneft and could still be realized. Planning for the USD 6 bn project is slowly ongoing with approval having been given by the local regions (Transneft, 2004-11-15). The other alternative in this direction is to ship oil to the North West and the Murmansk / Barents region. The grand pipeline plan by the major private oil companies to connect the Timan-Pechora area with Murmansk has been taken over by Transneft that still talks about the line in its medium term plans. On the Pacific coast, a number of the Sakhalin projects will come on steam during the coming years and are currently constructing export terminals. The first new export terminal, for Sakhalin-1, will be located in the Russian mainland, in De Kastri in Khabarovsk Krai, where the first test voyage was made with a 100 000 dwt tanker in 2002. Deliveries of the first of the ice-strengthened and purpose built tankers for Sovcomflot and Prisco, the companies that were awarded the transport contract, will take place in early 2006 (Sovcomflot, 2004-11-15). Also for the Sakhalin-2 project, a similar terminal will be built in the very south of the Sakhalin Island, at Kholmsk.

In the southern direction over the Black Sea, it has become a major problem for Russia that the outlets to the Mediterranean Sea, the Bosphorus and Dardanelles straits are on the busiest waterways in the world. Over the last ten years, it has become an even more important route for the Russian and other former Soviet states, for the export of especially crude oil to world markets. In 1998, Turkey implemented new rules, e.g., banning tanker traffic at night through the strait, to increase safety. Only since 2001, traffic through the straits has risen by over 30%, reaching 135 mt during 2003 and is expected to increase by another 20% during 2004. According to Turkish maritime officials, a volume equaling four loaded 100 000 dwt tankers per day pass the strait during the year. The increasingly frequent delays for ships passing in the strait have, by the Turkish authorities, been blamed on the increased traffic. During only December 2003, delays at the Bosphorus and Dardanelles nearly doubled shipping costs for about 1 million-barrels of crude cargoes.

Turkey, together with the US, has been the main actor in pushing for the building of the Baku – Ceyhan pipeline. A USD 2.6 billion pipeline for crude oil is being constructed that will connect the Caspian Sea region with the Turkish

oil terminal of Ceyhan. Together the two successfully lobbied international oil companies to connect this oil terminal, in the northeast corner of the Mediterranean Sea, which is also connected by pipeline to Iraq, with the Caspian region. This project could be seen as an attempt to reduce tanker traffic in the Bosphorus, and alternatively, as a way to reduce Russian influence over oil transports in the Caspian Sea region. Work on the oil pipeline commenced in 2002, and on a gas pipeline in 2004, despite strong concerns from opponents and environmentalists that the route chosen was not economically viable. Fears that are increasingly likely to prove correct, as construction costs are souring. The construction co-coordinator, BP, have admitted that costs have increased to approximately USD 3.2 bn (Itar-Tass, 2004-12-21). Also costs for the gas pipeline has increased from its initial estimations of USD 3 bn to over USD 3.5 bn.

For the future, the capacity of Russian export capacity will have increased to over 430 mt according to Ministry of Energy. Out of this, some 60 mt will be transported by the Baltic Pipeline System towards the Baltic Sea, some 15 mt towards other terminals in the area, some 70 mt via the Caspian / Black Sea. The large change is to be found in the Murmansk area where a new pipeline is planned delivering 80 mt from Western Siberia – Timan – Pechora – Murmansk (Transneft, 2004-10-26). Somewhat surprisingly the plans does not include any export pipeline at all in the Asian parts of Russia, as what will be dealt with below.

### **The Russian pipeline project to China / Japan**

Noticeable in the description above is the lack of established connection to the world's fastest growing market, neighboring China, where oil consumption is expected to increase by double-digit figures in the coming years. Although Russia wants to maximize the price received for the export of its strategic oil and gas resources, depending on the direction, the national strategic interest can be strongly influenced by what is pure economic interests. In Siberia, the two pipelines under discussion has been intended to lead oil from Angarsk, west of Irkutsk, to the Chinese oil refining centre in Daqing in the province of Manchuria. While the alternative pipeline proposed by Japanese interests would by-pass China and lead directly to an export terminal on the Pacific coast. Of the two alternatives, one offers a shorter line, but results in China as the sole buyer and difficulties to set prices, while the longer alternative opens up the possibilities to sell to a wider market.

The long discussion about the destination of the pipeline from Siberian oilfields eastward has been especially frustrating for China. On the Chinese side, construction work for the pipeline was started, but oil is currently being delivered by rail, in much smaller quantities than what the proposed pipeline

would be able to carry. After years of negotiations, the Chinese government has still no confirmation from Moscow that a pipeline for the export of crude to China will be built in the foreseeable future. From the Chinese side, the objective is to reduce its dependence on first of all, Middle East oil, but to what extent this means that China is prepared to pay a higher price for this “*spreading of risk*” remains to be seen.

By mid 2002 the prospects looked positive for the construction of a Russia-China oil pipeline. When the initial investment blueprint for the pipeline was presented, it included two possible routs, the somewhat shorter through Mongolia alternatively directly to China, but also two destinations, either Beijing or Daqing in Manchuria. The Russian side favored the 170 km shorter route through Mongolia while the Chinese side preferred to avoid Mongolia to lower the political risks. During Deputy Prime Minister Viktor Khristenko’s visit to Beijing in April 2002, the pipeline project was the main topic of discussion. Funding for the pipeline on the Russian side should originally come from the second biggest oil company, Yukos alone, while on the Chinese side it was the National Petroleum Corp (Chinaoil) that would fund the connection. Yukos, as the sole Russian partner, later came to be supported by Transneft, which put aside its earlier doubt and decided to participate in the project. Chinaoil was the contract partner when Yukos in 2003 signed a preliminary 25-year deal. The agreement indicated that 700 mt of crude should be delivered to China over 25 years, given an average of 28 mt/year, at a cost of USD 150 bn. How the financing should be solved was never made clear, although Yukos executives had indicated that the Russian side would contribute about USD 700 million and Chinaoil the remaining part. The pipeline's total length was given at 2 400 km, of which 1 400 km was in Russia. A slightly changed routing was presented that better took into account the environmental concerns about the potential risk of oil leaks, that might pollute Lake Baikal, as the new route passes further away from the lake. Construction was originally planned to start in 2003 and the first oil should reach Daqing in 2005. Initially at a rate of 20 mty, and by 2009, deliveries should reach the 30-mty level, with oil pumped from fields in Sacha/Jakutia.

This development brought Japanese officials into action, and the former Prime Minister Yoshiro Mori, Foreign Minister Yoriko Kawaguchi and other officials arrived in Moscow to urge Russia to instead cooperate with Japan (RosBaltConsulting, 2004-03-22). Although such a venture would mean that a 60% longer, 4 200-km, pipeline from Angarsk to Nakhodka had to be built. In April 2003, the Russian government announced it would authorize the construction of a pipeline to Daqing, with a 20-mty capacity, and the intention to study a second 25-mty pipeline to Nakhodka. It later changed its mind, after

continued lobbying from Tokyo, to further investigate if it could be possible to build the Nakhodka leg first and the China pipeline later. A major insecurity with the Nakhodka alternative is that it is probably more difficult to set a fixed price for the oil arriving in Nakhodka. This is because the Japanese oil sector is private and the price paid at the end of the pipeline is therefore likely to be subject to full market exposure. For the Chinese alternative, prices could probably be expected to fluctuate less, but also become much less profitable in times of high demand/prices.

In late February 2004, the Russian government, through its then Minister of Energy, Yusufov, announced that the choice of direction for the Asian pipeline project has come to lean towards the project outline suggested by Japan. Turn of events that can be seen as surprising as Kremlin had long seem to priorities greater cooperation with China. President Vladimir Putin had stated that the level of relations between Russia and China was "*higher than ever*" and that bilateral economic relations were "*below potential*" (Kremlin, 2004-03-12). This was a statement that opposed what has been previously been made public by the state controlled pipeline operator Transneft. Transneft had argued that the resources in the oilfields taken into production in the region would not be large enough to justify an investment of this scale. A statement that, for good reasons, can be questioned as the construction of the pipeline between Kazakhstan and China (from Atasu to Alashankou) was initiated in the end of September 2004. A project that is based on smaller findings than in Siberia, nevertheless, this 1 000 km line is planned to deliver 10 mty to China from late December 2005 (RFE, 2004-09-29).

The China and the Japanese/Pacific alternatives carry two distinct price tags. The much shorter Chinese alternative is estimated to cost in the range of USD 3 bn while the Japanese/Pacific coast alternative is expected to cost in the range of USD 16 – 18 bn. For both alternatives, the final cost is dependent on the capacity of the pipeline discussed. In the case of the Pacific alternative, anything from 20 mty to 80 mty of capacity has been mentioned by different actors, while the Japanese credits has constantly been referred to as USD 7 bn. During the visit of President Putin to Beijing in 2004 the Chinese pipeline offer was extended to even finance the pipeline to China. To complicate matters, the building of the pipeline towards China had its initial backing from Yukos that controlled the nearby oil resources through its subsidiary Yuganskneftegaz. Since then, the tax-debt campaign against Khodorkovsky/Yukos and the forced sale of its most important production subsidiary Yugansk, it is now the state through Rosneft that controls Yugansk. The sale of the most important reserves for the pipeline projects made it possible to finally take decision to scrap the Chinese alternative. Instead, the most far-reaching promise to supply oil to China by railway has

come to be made by Rosneft, now controlling the original finding that Yukos based its original Chinese contracts on. For the next five years, Rosneft has committed deliveries of 4mt of oil for 2005 and with deliveries to reach 8 mt by 2010 (Rosneft, 2005-01-10). These deliveries are expected to repay the USD 6 bn loan from the Chinese side given to Rosneft in the takeover of the findings.

Construction costs for the pipeline are huge, but at the same time as demand goes up, so does normally the prices for transport/shipping. However, the price of transport is in this case also strongly related to the availability of transport capacity (i.e. suitable ships), but could swing 100% inside days, but also remain relatively stable. Average price for the transport of crude oil from Persian Gulf to Singapore in July of 2003 stood at Worldscale 52 and in the same month in 2004 at 165, and by the end of October, it had reached 247. Corresponding to a shipping price of USD 0.5/bbl in 2003, but at USD 1.6/bbl in 2004 for the Persian Gulf to Singapore leg, with contracts by October 2004 having been agreed at a shipping price of USD 2.6 bbl from the Persian Gulf to Japan (SSG, 2004-10-21)<sup>64</sup>. These are money paid for transport costs that alternatively could have been invested in a pipeline project to deliver oil from elsewhere. If the proposed pipeline from central Siberia to Nakhodka would carry about 80 mty, at an investment cost of about USD 18 bn (over 20 years), then that would correspond to USD 1.6/bbl<sup>65</sup>. There would still be some additional costs though to operate the line and to forward the oil to potential consumers.

State controlled Transneft is one of the most important players, being the government's right arm, as it simply waits for the government to pronounce its decision on the route. To merge the two projects could appear logical, but until the government makes its final decision, nobody can say what route will be chosen. What perhaps could be seen as a compromise, presented by Transneft and the Russian Railways, is to initially only connect findings to loading terminals along the BAM railway, leading north of the Lake Baikal to Chita, and to ship the oil by this under-utilized railway line. Such a project could be operated inside two years, while a pipeline to the Pacific would take up to seven years to build (Kommersant, 2004-05-27). In the Far East, Khabarovsk Krai has also started its own battle to change the final destination of the pipeline to the Tatarskiy Bay, near the ports of Vanino and Sovgavan (RRR, 2004-09-20). This would make the pipeline go straight to the east to reach the Pacific Sea from Khabarovsk, and not south into Primorski Krai and Nakhodka. The two alternatives are about 450 and 800 km long, respectively, with the longer to Nakhodka over relatively flat land while the shorter to Vanino passes a mountain ridge with 2000-meter peaks. A decision on the pipeline projects had first been expected in the late spring of 2004, then during the summer, but only to be postponed until the end of the year or early 2005.



It is time that Moscow come to address the fundamental questions, of how and which of the oilfields of eastern Siberia should come to be ready for production, and how soon. If not, it was expected that some indication of the decision would emerge during the visit of the Chinese Premier Wen Jiabao to Moscow in early October 2004, or during the return visit of Putin to Beijing only weeks later. Instead the President has stated that the decision will be based on "*Russia's national interests*". The Minister of Economy, Gref, has been more outspoken, having indicated that the problem is whether to build a connection to Daqing, after a pipeline to Nakhodka is completed (MT, 2004-10-18). This inability to decide also sets the Japanese lobby off against the Chinese, and makes this question of economic policy towards its neighbours become a crossroad at which the Russian government has long proven unable to choose direction. However, on the last day of 2004, Prime Minister Fradkov signed a directive of the construction of a USD 18 bn and 4 200 km pipeline in the direction the Pacific under the responsibility of Transneft (Rosbisconsulting, 2004-12-30). The line will, in this proposal, pass about 150 km north of Lake Bajkal, indicating both an awareness of environmental concerns and the possible use of the BAM railway for shipments during initial stages of construction.

### **The Sakhalin oil and gas projects**

The origin of the oil that will be shipped in the previously discussed pipelines to China and/or the Pacific coast will be pumped from mainly east Siberian fields. The only major oil and gas fields in the Far East where any major investments have been seen so far is on and around the island of Sakhalin. The first prospecting here started as a joint Russian – Japanese initiative from 1975 with geological prospecting and a large seismological survey of the continental shelf east of Sakhalin. Exploration covers the eastern shore of the northern 2/3 of the island, generally in a water depth of 25 to 150 meters. Already, the first test wells drilled was successful as both gas and oil were first found in 1977 (Rosneft, 2004-07-04). Initially, the construction of a pipeline to Japan was promoted for both gas and oil from the island, as the distance across the Le Perousse strait to Hokkaido is not more than 70 km. However, the idea has slowly faded away, despite having found initial support by the Japanese government. As co-ordination between the different projects seem to have been minimal, any such plans have been postponed for the time being. Since then, a number of supply deals have been signed between Japanese consumers with the different projects, including transport contracts by ship, which put it in doubt if a viable economic ground for a pipeline can be found. The drawback on the east coast of Sakhalin is that there is currently no technique to run year-around production and prospecting off the east of the island, due to the severe winter and the stormy conditions. It is not until the foundations for the fixed production platforms have been installed and reached the production stage, billions of dollars more will have to be invested in the Sakhalin projects; from 1 to 6.

The **Sakhalin-1** project and its three off shore reserves in the northern part of the island are estimated to hold over 300 mt of oil and 485 bn cm of natural gas. Overall, the project could be the largest investment project in Russia, being valued at USD 12 bn, of which about USD 2 bn has been spent (Sakhalin1, 2004-10-12). The first oil from the project is expected to reach the market during 2005 and produce at about 12 mty at the production stage. The oil will be transported from the drilling platforms, by a 220 km pipeline, across the island and on to Khabarovsk Krai territory. A new devoted deep water single point mooring facility has been built in De-Kastri, where 100 000 dwt crude carriers will be loaded from a similar size tank storage. The transport contract for the shipping of the oil from the terminal has been awarded to Sovcomflot and Primorsk Shipping that will build new ice class tankers for this. Also, Valdivostok-based Far Eastern Shipping Company has contracted two larger icebreakers for ten years to the terminal from 2005. Gas production from the S-1 project has only been said to supply customers in Khabarovsk Krai from some time in late 2005. Two contracts with local buyers have been signed. In the development of the Sakhalin-1 project, the leading operator, Exxon Mobil, has been faced with numerous problems and delays in the development of the field. Among these the larger subcontractors had problems to fulfill contracts, and contracts already awarded had to be split further to fulfill the building of the first terminal (Bloomberg, 2004-09-17). Exxon Mobile and Sodeco (of Japan) holds 30% each, while Rosneft and Oil & Natural Gas Corp. (of India) each have a 20% holding in the Sakhalin-1 project.

The **Sakhalin-2** project was the first of the project with the development rights granted in 1991, prospecting started in 1994 and with the first oil to be delivered in 1999. Sakhalin-2, or Sakhalin Energy Investment Company (SEIC), led by Royal Dutch Shell (55%), with Mitsui (25%) and Mitsubishi (20%) of Japan as partners, is so far the most successful of the oil projects off the coast of Sakhalin 1999 (Sakhalinenergy, 2004-08-11). Production from the project has reached about 1.5 mty and has gone up by about 10% over 2003. New large-scale findings will come into production from 2007 and a number of deals have been signed for delivery of gas to several Japanese energy majors for about 4 mt of LNG per year. Contracts signed for gas correspond to about 35% of the estimated production capacity of 9.6 mt that has been estimated. Sakhalin-2 has awarded the transport contract, valued at USD 350 million, to Japanese, Nippon Yusen (NYK - Line), that will supply the LNG shipping capacity needed (MT, 2004-09-09). A two-year construction project for the two southbound 860 km, and USD 2.5 bn, oil and gas pipelines initiated in early 2004, but since been partly postponed. The two pipelines are intended to deliver products to a liquefaction plant and an oil terminal on the southern gulf of the island, near Kholmsk, from the two production areas off the coast in the northeast. This

construction project has come under heavy environmental criticism, as the pipelines will cross over, and not under, 29 major rivers and will be built underground, not on pillar support, in an area of strong seismic activity<sup>66</sup>. Additionally, with connecting offshore lines from the three production platforms crossing, what probably is the only summer breeding ground in the world for grey whales (WWF, 2004-08-12).

Additionally Russia is said to be about to sign a 20-year agreement with South Korea to provide 5.3 million tons of natural-gas condensate from the Sakhalin gas fields annually. The likely supplier in the deal is the Sakhalin-2 consortium, which is currently constructing a plant on Sakhalin for the production of liquefied natural gas. The proposed deal, which is believed to be worth USD 830 million per year, will include a subcontract under which Russia will purchase condensed-gas tankers from South Korea shipbuilders to transport the fuel from Sakhalin to South Korea (Izvestiya, 2004-08-10). In line with this deal Korgas, the Korean national gas company, has been invited for discussions of joining the project as a future minority owner (Kommersant, 2004-09-23). Also the biggest oil refiner in Asia, China Petroleum and Chemical Corp., is reported to be interested to join the Sakhalin-2 project, as the first Chinese buyer of liquefied natural gas from the Sakhalin projects (Bloomberg, 2004-08-17).

The tender from 1993 for the rights to the **Sakhalin-3** project, which was then won by a consortium led by Exxon Mobil (33%), Chevron Texaco (33%) and Rosneft (33%), was annulled by the Russian Government in March 2004. The official reason given was that exploration had not been initiated, by the two partners, as was specified in the contract. Sakhalin-3 holds very large reserves, but these are spread out over four fields along some 250 km of the coast. Total reserves here have been estimated to over 800 mt of oil and 1.4 tncm of gas (Rosneft, 2004-07-04). A new auction of the development rights is expected to be hold during 2005.

The project license for **Sakhalin-4** was won by Rosneft, in cooperation with BP, now TNK-BP. It is only expected to contain about 100 bn cm of gas, but due to the geological structure of its reservoirs, it will be jointly developed with the Sakhalin-5 project (Rosneft, 2004-07-04).

The development of the gigantic **Sakhalin-5** project has, from as late as in April 2004, come a step closer to its initiation. All initial costs up until production start will be financed by the 49% partner TNK-BP alone, but in a JV with its 51% partner Rosneft. Of the two, it is Rosneft that holds the so important drilling rights for the project<sup>67</sup>. As the initial agreement to develop the filed between the two companies, signed in 2001, was due to expire in 2004, some kind of

continuation was not unexpected. It can also be expected that other foreign companies had been looking for a stake if BP had not finally stroke a deal. BP had probably wanted an even split of initial costs, but Rosneft will not contribute until the first oil has been produced. As in all raw material exploration projects, estimations of the total Sakhalin-5 development costs depend on the final size of the project and how soon the production stage should be reached. Development costs needed to reach production at the field have been estimated to anything between USD 2.5 to USD 5 bn. Explorative drilling commenced in 2004, and at the end of the drilling season, Rosneft declared that, what it called “*significant amounts of oil and gas*” had been found off-shore in the first attempt (Rosneft, 2004-10-06). In perspective, the Sakhalin-5 is expected to reach an output level of crude and oil-condensate of 600 mt, and to hold a total of 500 bncm of natural gas. Currently, 2010 estimated as the most probable year for the first deliveries. By its assignment here, BP is increasing its already strong commitment in Russia, where now one in five BP barrels are being produced (BP, 2004-06-12; Reuters, 2004-03-09).

The license to the **Sakhalin-6** project, holding one large field, is held by TNK, but now part of TNK-BP. The drilling of two exploration wells for that project is scheduled to take place during 2005.

Out of the three projects that have reached the production stage, or near the production stage, Sakhalin 1 and 2 are conducted under the PSA legislation while the Sakhalin 5 is working under normal Russian tax legislation (Itar-Tass, 2004-10-07). Under PSA agreements, profits are divided between the project partners and the government after the costs that in advance has been approved among partners and the government has been covered.

Early on much criticism of these projects was focused on the sensitivity of the environment in the region to degradation from the oil spills and effects on indigenous population groups. Not much discussion has been seen concerning where terminals are being constructed or where pipelines have been laid, apart from against the Sakhalin-2 pipeline. The first major disaster struck in September 2004, with what still must be considered as a small spill, seen to the volumes handled by the different projects. It came to be caused by a dredger, carried onto the coastal rocks by a typhoon, spilling 200 tons of fuel-oil (Vladnews, 2004-09-14).

### **2.3.2. Gas**

Similar as for oil, the production of natural gas has, over the years since WW II, come to move from the first fields in central Russia towards the North East. As in the case of oil, the new gas findings were first found in the southern Urals and then further to the North East. In the years just after the war only a few percent of the Soviet gas was produced east of the Ural Mountains with nearly 60% was produced in what was to become CIS states. The Siberian share was still one digit by 1975, but had reached over 35% by 1985. In the same period, the average transport distance of the gas more than doubled to over 2 500 km, which was also due to new pipelines connecting the Urals from far away Uzbekistan and Turkmenistan. The trend that the findings will be located even further away from consumers has continued, and will continue, as the next generation of large fields will be developed on the Tajmyr peninsula, in the very north of Siberia. The go-ahead signal for the development of the giant Yuzhno-Russkoye in the area has been given and it expected to come into production by 2007 (Gazprom, 2004-11-15). As near half of both heating and electricity has natural gas as its energy source, over 50% of Russian primary energy consumption constitutes of natural gas, with the same figure coming to about 25% in both the EU and the US.

During early transition years of the 1990s, the consumption of natural gas in Russia declined considerably less than other forms of energy sources during the same period. This tendency had increased the importance of gas in domestic energy use, at the same time as exports of gas fell less than for oil during this period. In 2004, total production increased by less than 1% to 545 bncm at the same time as oil production was up by 9% to reach 12 mt for the year (Gazprom, 2005-01-25). Plans for 2005 are expansive and include a production volume of near 550 bncm. Exports outside the CIS are expected to reach 145 bncm and investments in pipeline construction will be tripled, to near USD 2 bn (Gazprom, 2004-11-10 - - 11-24).

The production of natural gas in Russia has, since the break up of the Soviet Union, remained a near monopoly under the state-owned company Gazprom. Gazprom controls most parts of the near 160 000 km of gas pipelines available in Russia, and especially so the large diameter interregional and export pipelines. Additionally, it is not only the world's leading supplier, controlling near 90% of the domestic production, but is also supplying 25% of Europe's gas needs. The importance of the company is somewhat shown by the size of its staff that already before its recent mergers, was over 300 000. Also, the earnings of Gazprom are impressive at over USD 19 bn for exports outside the CIS, up by 16% over 2003, from exports of 140 bncm (+6%) and an additional 52 bncm to

CIS countries (Gazprom, 2005-01-25). International gas deliveries have a long tradition and were initiated with the building of a pipeline to Finland in 1974, and for which current delivery contract of 5 bncm extends to 2025 (Fortum, 2004-09-29). However, total earnings are slowly falling as a result of higher costs, as input prices are up by over 20% during 2004, at the same time as gas prices are set by the state and can only be raised by way of government decisions. Gazprom has demanded the government to allow prices to go up by 23% for 2005 if it should not be forced to reduce investments considerably and to make a loss on domestic sales as extraction tax is due to increase. Over 80% of revenues during H1 2004 earned from exports, where average prices are 2.6 times higher than domestically (Gazprom, 2004-08-15).

Gazprom has long been listed on the Russian stock exchange, but with only a minority of shares available to foreign and a larger part to domestic investors. The dual trading system has received much criticism as it has been suspected that foreign investors own considerably more than the allowed 15% of the company. With the merger of Gazprom and Rosneft, which will take effect in 2005, the 50% -1 share, that is not owned by the state, will be available for free trade<sup>68</sup>. Gazprom also produces oil and its 2003 volume of oil and gas condensate places among the six largest oil producers in the country. During the merger discussions, it was also made public that Gazprom has acquired over 10% of the electricity utility UES, further increasing its weight in the energy market.

Despite its size, Gazprom is also in need of foreign partners for continued expansion and American Chevron Texaco has agreed with Gazprom on a “*gas-sector cooperation*” deal (Gazprom, 2004-09-22). The development of the giant Shtokmanovskoe offshore gas fields containing an estimated 3.5 tcm and 30 mt of gas condensate, but located 380 meter under the Barents Sea (RosBaltConsulting, 2004-09-22). In an attempt to start building a customer base for LNG in the US, Gazprom will in 2005 start swapping gas delivered in Europe for LNG delivered in the US. To be replaced by LNG that will be shipped from Gazprom’s own fields inside a few years time. When the approximately USD 10 bn needed has been invested in the Shtokman field, it will be well positioned for deliveries to the quickly expanding US LNG market (Bloomberg, 2004-09-25). The rights to develop the field are held by Rosneft (due to merger with Gazprom) and Gazprom. To support its export plans, Gazprom will also build an LNG export terminal west of St Petersburg, together with Petro-Canada (SeaNews, 2004-10-11). This project is bound to connect to the planned laying of an export pipeline under the Baltic Sea, from the Gulf of Finland to Germany. A possible future connection to Finland and Sweden from this pipeline is under study. This North European Gas Pipeline (NEGP) under study by Gazprom and

its German importer Wingas, could carry 20 – 30 bncm/year, with its 3 000 km route chosen in international waters to avoid the kind of transit problem like what has been seen in Belarus and the Ukraine (Gazprom, 2004-10-10)<sup>69</sup>.

At the same time, the development of the offshore Shtokman and the northern Yamal Peninsula fields are indications of a trend where the cheap-to-develop fields are slowly getting depleted and the new large fields are proving increasingly expensive to develop. The latest survey made public on 90% of the resource base of Gazprom, including proven and probable gas reserves at end of 2003 have come to 16.8 tcm proved reserves, plus another 1.9 tcm probable, down 1% on 2002 (Reuters, 2004-07-22). Also, the approximately 10% slice of Russian gas that is not being controlled by Gazprom has been attracting international attention, with the French oil major Total buying 25% of the second in size gas producer, Novatek, at USD 1 bn (RFE, 2004-10-05).

Only in the Siberian part of Russia, the gas reserves have been estimated to about 45 tcm, of which 33 tcm in Eastern Siberia and 12 tcm in the Far East. This accounts for about 20% of Russia's initial overall natural resources (Gazprom, 2004-09-21). One of the biggest fields in the region is the Kovykta field, located some 400 km to the north west of Irkutsk. It is estimated to contain more than 2 tcm of gas reserves, and was long seen as the field that would supply the gas for a pipeline to Asia. It is the company Russia Petroleum who holds the production rights to the Kovykta fields, to 63% controlled by TNK-BP, with other owners being the industrial group Interros and the local administration. In early 2003, Russia Petroleum signed a preliminary agreement with consumers in China and South Korea to supply gas from the field, beginning in 2008, with deliveries reaching 30 bncm per year within two years. When Gazprom was made state coordinator for all Russian international gas projects later in the same year, BP offered Gazprom a stake in the field, but Gazprom wanted 50% of the venture and not only the 37% offered by Interros and local authorities. Negotiations have continued and a preliminary, but not public, agreement is said to have been reached (Bloomberg, 2004-08-23). In early March 2004 TNK-BP agreed with Irkutsk authorities to supply major consumers in the region with 300 mcm of gas beginning from 2006, and rising deliveries to 2.2 bncm by 2009. Total investment in the Kovykta field from 2004 until 2009 will amount to approximately USD 650 million for this local project, where the implementation will not depend on possible terms of international projects (TNK-BP, 2004-08-10). Additionally, TNK-BP has also signed an agreement with two domestic companies to extract helium that is also contained in the gas field, at a USD 40 million plant that will be build at the site for that purpose (TNK-BP, 2004-05-26).

Gazprom has been chosen by the government to co-ordinate gas export from the Far East, but has not shown any enthusiasm for export plans in the direction of Asia. Focus for the company has been on the sale of gas locally and in Europe; with CEO Miller having stated that Kovykta gas should go west and that Sakhalin is the most important finding in the Far East (Bloomberg, 2004-10-05). Gazprom has become a partner in Sakhalin-1 project and has indicated an interest also to participate in Sakhalin-2. One of the major problems in the Russian negotiations with the EU and WTO is that the state-controlled domestic gas prices have been kept at about 20% of the about USD 140/1000m<sup>3</sup> that EU companies pay Russia (DG-TREN, 2004-07-20). In the bi-lateral preparatory WTO negotiations between the two, Russia has promised to raise prices for gas for business users. Export value of gas during 2003 came to USD 16.5 bn for a volume of 141 bncm sold, with 2004 expected to become an even more profitable, as volumes are expected to reach 150 bncm and prices will increase by approximately 15%. Contracts already signed up to 2008 will set export volumes to no lower than 147 bncm (PetroleumNews, 2004-09-19).

### **2.3.3. Coal**

In early Soviet Union years and up to the 1950s, the burning of coal was the backbone of the energy sector. The importance of coal peaked at some 60% of energy supply, but has since fallen to well under 20% by 2004. Despite a continued increase in production of coal until the 1980s its economic importance continuously declined, due to the even more rapid raise during this time in oil production and oil use. The use of coal is no longer as wide spread as it used to be, but power stations and the steel industry remains the most important users of coal.

During Soviet years, the extraction of coal was one of the most heavily state subsidized undertakings. Incomes from the sale of coal made up less than half the cost, with that state contributing what was needed in different forms of subsidies. Already before the break-up of the union, more than half of especially smaller mines were deemed unprofitable, often with production volumes as low as 500 000 – 600 000 ton per year. In this sector, nearly half of the mines were lost to other countries of the CIS, while in the oil and gas sector, only a minor share in number were located outside of Russian territory. At that time, only one in five of the mines had a technical standard comparable to the west and many of the shafts of underground mines were of such poor standards that they were right out dangerous. Based on this, the sector was left in a very complicated situation already at the start of the transition years and the production volume inside Russia fell by over 50% during the 1990s (IEA 2004-10-10). Reforms have



made progress, although slow and irregular, which in this case has led not only to the closure of a large number of mines, but also wide spread privatization. The international support from e.g. the World Bank has been strong, focusing on assistance in the social transformation for the employees becoming unemployed in the process (WB-Ru, 2004-07-07). Still, protests against closures and wage arrears by miners have been many, and sometimes also violent. The situation in the sector has reached a more stabilized stage in later years. The privatization process has more or less been completed in the coal sector, where private ownership has increased from something like 40% in 1998 to about 95% by the end of 2003.

In later years, the volume mined has been in the range of 250 mty but has in later years slowly increased to reach about 280 mt for 2004 (MOIE, 2004-12-29). In 2003 Russia exported 36 mt, or 7% of world exports of thermal coal, having increased to 37 mt during 2004, but with cooking coal export increasing rapidly to near the same volume, or 32 mt (FSSS, 2004-10-10, and Bloomberg, 2004-12-24). On the export side, it is distance that is causing two major problems for the industry. First; about 80 – 90% of the Russian coal volume is being mined in the Kuzbass region, in and around Kemerovo, and from there it is often 4 000 km to the ports. As a result up to 30% or more of the final price quoted for the export thermal coal could refer to transport costs (Coaltrans, 2004-10-18). Second, rail cars, that can load 60 tons, often combined in a 70 car or 3 500 ton trains, can hardly be expected to do more than 15 trips to a port per year. Despite such problems, export remains an attractive economic alternative, but the lack of rail cars for transport is bound to limit the export potential for years to come (SUEK, 2004-10-20). Problems are also the handling at the ports. As has happened before during winters, trains get stuck on the lines when unloading capacity is not sufficient and the coal is frozen. In late November 2004 this happened again with about 150 coal trains waiting to be unloaded at ports in St Petersburg and Murmansk, with as many more under way (Bloomberg, 2004-11-25). However, far from the full export volume is destined for the ports as some of the export is also bound for CIS destinations.

Despite having the largest reserves in the world, Russia has not yet seen any of the world's four coal majors, BHP Billiton, Anglo, Rio Tinto, and Xstrata/Glencore having invested in any of the Russian mines. In Russia, it has instead been the large metallurgical companies and important financial industrial groups who have business interests in different industrial sectors, and especially metals and steel, that have shown an interest in coal mining. Today, the Russian coal market has essentially become divided among three main players: the Siberian Coal Energetic Company (SUEK), EvrazHolding, and Severstal; the last two being principally steel companies.

#### **2.3.4. Electricity**

The majority state-owned Unified Energy Systems (UES) is not only Russia's biggest producer of electric power, but it also controls the national electric power grid. The distribution network under the control of UES reaches a total length of about 60 000 km of major lines. The UES, in the same way as Gazprom, especially dominates the interregional high voltage lines and the export lines. All together the UES controls about 440 electric power stations with a production capacity of 197 GW, with 20% of this coming from nuclear power (UES, 2004-10-09). Alternative energy sources find little room in Russia, and the only three thermal plants inside UES (and Russia) can all be found on Kamtjatka, with a combined capacity of 70 MW. During 2003 UES produced 790 TWh, out of a national consumption of 860 TWh. During the first nine months of 2004, consumption increased just over 2% to 650 TWh, out of which UES supplied about 70%. Most of the increase was generated by the UES hydropower plants, which boosted their output by 15% during the period, as a result of above average water flows in the rivers (Bloomberg, 2004-10-05). For the future, increasing demand will force UES and others, to increase capacity more rapid than the 400 MW installed during 2004 and the 1 300 during 2003 that was installed by the UES (Prime-Tass, 2004-11-05).

Spread over the country, there is also a large number of, mostly regional/oblast, vertically integrated power generators / distributors. To a varying degree, also these are often being indirectly controlled by the UES. UES is currently one of the most highly valued companies on the stock exchange with a long awaited political reform of the power distribution system, which is likely to influence much of its future value. The biggest producers outside of UES are Mosenergo (in Moscow and on the stock exchange) and Irkutskenergo (in Irkutsk and state-controlled) which have installed generation capacities of about 15 000 and 14 000 MW respectively<sup>70</sup>. Regional energy companies, which are often under the control of the different oblasts, have been used to support large local industries through subsidized price policies. As for many other sectors in the country, a major problem during transition years has been non-payments from its customers. Non-payments have been a long running problem for the electricity suppliers, which worsened after the crises in 1998. With the state, through the military, as one of the largest debtors and one that in numerous cases cannot be denied deliveries for security reasons. Since, the debts and non-payments problems are slowly approaching acceptable levels. However, the results of the lost incomes have; and been that severely cash starved power generators have, for many years now, been forced to refrain from much needed maintenance work and other investments. Consequently the quality of the grid has deteriorated to alarming levels, including a long backlog in the upgrading of equipment.

In the NEA direction, the Russian electricity giant UES has signed a partnership deal with Chinese Datang to open for joint national and international projects of infrastructure development (RJ, 2004-09-01). Increased economic activity in China has made electric consumption rise sharply, and so has the Russian electrical power exports to China, which is expected to reach about 235 million kWh in 2004.

### **2.3.5. Nuclear**

Russian nuclear power is the fifth most important energy source on the domestic market after natural gas, oil, coal, and hydropower. In 2004, Russia had nine nuclear-fuelled power producing stations with a total of 29 reactors in operation<sup>71</sup>. During 2003, Russian nuclear power stations increased their generation by 6.3% to 149 TWh, or about 11% of total production of electricity in Russia. A production level that is 16% above estimated maximum in Soviet years, with much of the 2003 improvement achieved from a 4.5% increase in capacity utilization. A rate of production increase around 5% per year is foreseen in the coming 15 years, as the share of electric production from nuclear plants should rise to near 20% by 2020 (Minatom, 2004-04-02, IAE 2004-04-02)<sup>72</sup>.

Seven of the nine nuclear power stations are located west of the Ural Mountains. There are two dominating designs of these reactors with 13 being VVER's (pressurized water reactors) while 13 are of RBMK design (graphite-moderated reactors). Of the RBMK reactors, four can be found in Sosnovy Bor, 80 km west of St Petersburg, where all reactors are of the most unsafe type. The first two reactors here were brought into operation already in 1973 and 1975 respectively and reached the end of their technical lifetime in 2003 and 2005. But this has not happened, on top of this, the three research reactors at the same site, aimed for training of submarine crews, are also in operation. Used fuel elements from RBMK reactors can, to date, not be upgraded, in contrast to elements from the pressurized water reactors, at the same time as no Russian centralized long-term storage facility has been built. In the case of Sosnovy Bor all old fuel cells from its reactors are stored under doubtful circumstances less than 50 meters from the Baltic Sea (Bellona 2004-05-10). RBMK reactors are the type that "*must be shut down*" and any investments in safety, like in Sosnovy Bor and the Lithuanian Ignalina reactor, shall only be seen as temporary (IAEA, 2004-05-15)<sup>73</sup>. The low local confidence in the security measures surrounding domestic nuclear power was shown by the panic caused in Saratov, from what proved to be just rumors, of an accident at the largest power producer in Russia, the nearby Balakovo nuclear power station (RJ, 2004-11-05 - 11). Even President Putin has called for increased safety at nuclear power plants, although his chief concern was related

to the risk of terrorist attacks. Stating that there are currently some 70 million tons of solid nuclear waste in Russia. Additionally there are considerable problems in both decommissioning reactors, especially from the Navy, but also in cleaning up areas contaminated by military and civil nuclear activities (Ria-Novosti, 2004-12-16).

The Soviet Union, and later Russia, used to have an additional 13 nuclear reactors to produce weapons grade plutonium oxide, of which three are still in operation while all 14 in the US has been closed. Large US investments, USD 688 millions in 2003, have so far managed to close ten of the Russian ones, with two of the remaining located in Seversk and one in Zheleznogorsk (ibid.)<sup>74</sup>. These three still produce 1 500 kg of plutonium per year as a by-product, but first of all electricity for surrounding areas, for which there currently is no replacement, and because of that the plants cannot be closed<sup>75</sup>. It has been planned to build new thermal power stations to replace these, but that will not be ready for the scheduled closing of the stations in 2006. The conflicting interests are, at the same time, openly obvious as the former ministry, Minatom, has two new reactors on the drawing board, BREST and BN-800, that are plutonium based (Minatom, 2004-05-10). Development has continued, in co-operation with German Siemens, to develop a fourth generation of pressurized reactors. For the smaller of the two, the intention is to use a submarine type of reactor to generate energy at a floating station in far away areas, e.g., along the Arctic coastline. In 2003 the Duma approved the continued construction of a full-scale model at the submarine shipyard in Severodvinsk, west of Arkhangelsk. This kind of reactor has also been offered for export to both India and Indonesia during 2003.

Reactors based on Russian technology have been constructed in nine other countries, with the much-criticized ongoing construction of a new reactor in Iran as the most recent one. These countries are Finland (2 reactors), Hungary (4), Slovakia (4), Czech Republic (4), Bulgaria (6), Slovenia (1), and Armenia (1) that all house the considerably less dangerous VVER reactors<sup>76</sup>. Of the three RBM “*Chernobyl type*” reactors in use outside Russia, two can be found in Lithuania while one of the 15 Soviet design Ukrainian reactors is of this design<sup>77</sup>. The reactors at the Lithuanian plant are due to close in 2005 and 2009, respectively, after the EU has promised about USD 600 million in compensation (Le Monde, 2004-04-15). This sum could serve as an indication of the extra costs involved for the closure ten years ahead of estimated lifetime, in a country that is to 70% dependent on electricity from this one plant.

Russia is also one of the major producers, and most active exporters in the world of uranium to fuel nuclear power plants. New contracts for the delivery of fuel have recently been signed with Hungary, India, Slovakia and the Ukraine, with

exports having increased by 25% during 2003. The overall value of the exports of fuel and equipment from Russia in this sector increased by 15% to USD 3 bn during the same year.

Another much debated aspect surrounding nuclear activities has been the Russian potential as a future recipient of radioactive waste from abroad. Suggestions for this have not only been met by outrage from regions in Russia where transports would have to pass through, but also from environmental circles in possible exporting nations. The two possibilities on offer for waste treatment are reprocessing or final storage at one of the two mentioned Siberian facilities of Seversk and Zheleznogorsk, respectively (IAEA, 2004-05-15). This is not an alternative without interest in certain circles in the EU, where nuclear currently accounts for about 1/3 of electricity supply with four of the new EU members operating outdated and dangerous Soviet made nuclear reactors (DG-Tren 2004-05-24). It is not very difficult to find encouraging statements for such an export from respected circles *“There are a lot of places to put waste in Russia”* (D. Taylor, Head of Science Magazine, 2004-05-10). The building of new plants inside the EU has even been restarted, as at the end of 2003 the French state owned EDF-company won a contract to build the first new nuclear reactor for over a decade, of EPR type, planned in Finland<sup>78</sup>. By far France is the biggest user and has 58 nuclear reactors operating in 19 nuclear power plants that in 2003 produced 78% of the country’s electricity (“Euroatom” at Cordis, 2004-05-17). Of the countries with active nuclear power stations in the world, it is only Sweden, Finland, France, Germany and the US that has come anywhere close to start building a deep repository for high-level nuclear waste (LBL and SKB, 2004-05-15). Minatom has indicated its intention to build a similar facility in the vicinity of Krasnoyarsk, but has so far not given any further details on the advancement of the project.

## **2.4. Transport**

One of the greater challenges facing manufacturers, as well as importers and exporters, of products in Russia is moving these products over long distances to and from ports, but also to get products distributed to potential consumers. There are still problems facing transporters on all levels, from the lack of supply to problems with the quality of the existing infrastructure. Despite that much has been invested at all levels of the sector in later years, still many basic problems remains. This is due to years of neglect in maintenance and investment during Soviet years, and long into transition years, which has generally left infrastructure in a very poor starting position for its build-up.

Transport statistics for 2003 show that there was a general growth in volumes, lead by aviation that increased by 11% for the year. It was only municipal transport that showed negative figures, -4%, which is consistent with the trend of an increasing number of private cars and bus companies. On the cargo side, the railways increased their freight volume by +10%(Mintrans, 2004-05-03). Still further growth of transport volumes, in line with continued economic growth figures, will become increasingly difficult to cope with as aging infrastructure and an ever increasing transport lack of modern transport means will restrict capacity.

Much of the problem in the transport sector can be derived from the fact that the price of the transport service (it could also refer to a product) during Soviet years were never allowed to reflect the true cost of supplying the service. Under pricing was an epidemic inside the transport sector, compensated for by direct or indirect subsidies. Setting prices lower than the true cost give rise to over-consumption and wasteful usage of a service, simply because the user is paying less than what he should. Another result of the constant subsidies given is that the efficient use of resources is not being promoted, because the operator knows that eventual losses will be compensated for. That the transport components share of the final price of Russian product is often 50%-100% larger than for comparable products in developed countries were normally some 10% of the price reflects transport costs. This large difference cannot only be explained by the large size of the country here, but it also indicates a considerable degree of general inefficiency built into the system, indicating a problem that affects all sub-sectors of transport, although for different reasons. The general lack of understanding that also transport services should be paid for, first of all by its customers, was demonstrated all too well in Russia during the summer of 2004. In the heated debate concerning the abolition of free traveling on local transport for large groups of the populations (and some other services), it was never discussed where the money would come from to pay for the service. As the American saying goes "*There is no such thing as a free lunch*", there is no such thing as a free transport service. It deserves to be repeated, free travels/transport leads to over consumption and misuse by some, while it is of no value what so ever for those who are out of reach for the service<sup>79</sup>.

A long-term plan, presented by the Ministry of Transport, for a new transport strategy was signed by President Putin in the fall of 2004. It is hoped that the introduction of the plan will lead to that the available transport infrastructure will be fully reorganized and considerably upgraded by 2025. The plan foresees that Russia, by then, should have created what the Soviet system verbally aimed for, but never achieved: "*a unified transport system*". A far-reaching overhaul of the national transport system will need annual investments of RUS 600 bn (over

USD 20 bn) and with just one-fifth of this coming from the federal budget (Interfax, 2004-03-03). Prime Minister Fradkov has stressed that there is a need for more private capital in the transport sector and hopes to see 60% of investments in all kinds of transport infrastructure coming from private sources by 2013.

### **2.4.1. Railway**

The Russian Railways (RZD) is the worlds largest, with a network of 87 000 km, which corresponds to around 10% of the world total, out of which about 42 000 km has been electrified. The RZD has inherited an organization from the Soviet railways, which was based on 32 local railway districts, out of which 17 are still operational inside Russia. The railways used to be organized under a special Railway Ministry that was said to be one of the most influential during Soviet years. Since the restructuring of ministerial structures after the presidential elections in March 2004, it has now been converted into a department under the Ministry of Transportation (RZD, 2004-08-10). The reforms inside the RZD, despite the fact that much remains to be done to create real competition, are nevertheless seen as impressive by European Ministers of Transport; especially when it comes to investments and increasing productivity, where the RZD has made a difference in its little over a year of existence. Impressively quickly, it has turned the corner from an inefficient state monopoly into a holding with an international credit rating, presenting its results under international accounting standards (ECMT, 2004-10-26).

RZD has so far proven a profitable company and looks to earn about 8 bn for the year and hoping to double that during 2005 (RZD, 2004-10-29). Faced with massive needs for new equipment and modernization that the government will not supply over the state budget, the RZD has been forced to borrow from the open market. Without the changes mentioned above, and the positive view taken by foreign institutions to the changes incurred, such lending would not have been possible. As a result, the RZD has been offered, and accepted, access to a gigantic loan from Temi, made up of a group of large European railway equipment manufacturers and banks. A loan has been set up with an upper limit of Euro 25 bn (USD 29 bn). Given over ten years, at an interest rate of 3%, it will open up for the possibility to partly pay back in the form of barter goods. The loan will enable RZD to upgrade and build a number of new lines, e.g. in north-central Siberia on the permafrost stricken Yamal peninsula, as requested by Gazprom. Seen to RZD's generally low evaluation among investment agencies, the size of the loan seems highly speculative (Bloomberg and MT, 2004-09-20). RZD is also working on alternative credit facilities and will issue Eurobonds to

attract money for other long-term investments. An initial issue will be for USD 400 million, scheduled for late 2004, and a second issue will follow during 2005 for about double that amount (Bloomberg, 2004-09-09).

### **Freight**

When measured in transport work the Russian Railways handled 1 510 bn tonkm during 2002, which was the third largest volume in the world, behind 2 290 bn tonkm carried in the US and the 2 044 bn tonkm carried in China (RZD, 2005-01-25). During 2004, the Russian Railways carried a volume of 1.220 mt, which was near 6% more than the volumes in 2003. The transport work during 2004 amounted to near 1 700-bn tonkm, which was 8% up compared to 2003 (ibid.)

To maintain volumes, the RZD intends to spend 1.2 trillion on new rail routes and 600 bn on its rolling stocks by 2010. About 1.5 trillion from the company and an additional 10% from the government on what was called “*non-commercial project*”, like upgrading rail routes in Chechnya. RZD ships 40 percent of Russia's cargoes, but currently has more than half of its locomotives and rail cars reaching the end of their standard working life by 2010 (RZD, 2004-06-14).

In a meeting with his Chinese counterpart in September 2004, the head of the RZD, Fadeyev, promised to greatly increase the transport capacity to China. Currently, the volume railed between the two neighbours reached 30 mty and this is expected to have doubled by 2010. On just the 400 km from Siberian city of Chita to the Chinese border an estimated USD 480 million will be spend in upgrading and double tracking during 2004 and 2005 (Vedomosti, 2004-09-24). Nearly the same amount will be spent on upgrades of the two other connections to China as RZD see it as a strong future market and that capacity elsewhere is being underused due to these restrictions. With also container handling by railway between the two having doubled during 2004, surpassing a yearly volume of 100 000 TEU, capacity must also be extended to be able to handle a continued expansion (RZD, 2004-11-26). Of the three crossings between the two neighbors, the one south of Ulan-Ude, connecting through Mongolia, is the one most in use, followed by the one south of Chita, connecting just east of Mongolia, while the third one is located just north of Vladivostok. Shipments along the whole TSR has never surpassed the 150 000 TEU per year volume despite its huge potential.

The oil shipments to China have come in the center of the debate as large Russian promises for oil shipments by rail have been done, that are to be handled by the RZD. During the visit of the Chinese Premier Wen Jiabao to Moscow in 2004, it was stated that 10 mt will be railed during 2005 and 15 mt by



2006 (MT, 2004-09-26). Also in the Far East direction, the RZD has stated that it can handle the shipment of as much as an additional 10 – 20 mty of oil by 2010. That is when it has carried through its 26 bn (USD 900 million) upgrading of lines in the region (Bloomberg, 2004-10-05). In the southern direction RZD has committed itself to invest USD 100 million in a new rail link to be build along the western shore of the Caspian Sea. Such a link, where construction will start in early 2005, will connect Kazvin in Russia with the Iranian city of Rasht, at the southern shore of the sea. 340 km of new tracks will be built for a line that is hoped to carry 6 – 8 mty within five years (RZD, 2004-05-20).

### **Passengers**

When measured in transport work, the transport of passengers on the Russian Railways was the fourth largest in the world in 2002 with 153 bn passengerkm, behind the 477 bn passengerkm transported in China, the 457 in India and 241 in Japan (RZD, 2004-08-10).

The near future planning of the RZD also includes the long discussed high-speed railway between Moscow and St. Petersburg. Evaluations of the need for infrastructure improvements are underway, which will include the elimination of all single level crossings on the 750 km line, before a contract that is to be signed with Siemens AG. In the current plans the first high-speed train will be running on the line by late 2007 (RZD, 2004-12-23).

During the first seven months of 2004, the passenger volume on the Russian Railways grew by 5% to just under 100 million passengers, indicating a full year volume of 175 million. On long distant lines the volume increased by just over 6%, while the passenger volume on suburban lines, fell by near 2% (Russian Railways, 2004-08-04). Passengers on international lines to neighboring countries for H1 2004, on the other hand, increased at twice the rate, or 12%. Examples of destinations with increased volumes were the Ukraine, +15%(near 5 million), Uzbekistan grew by 33%, while passengers to the Belarus were down by 9% and to Estonia by 23%. In all, the railways carried 9.4 million international passengers during the period (RZD, 2004-09-08).

### **2.4.2. Road**

The Russian motorway system includes slightly under 400 000 km of paved roads, from a total of about 950 000 km. The problem with this huge system is that it is still not enough, leading to a very low road density at the same time as the configuration of the network leads to high expenses for road transportation. The Russian road system in 2004 corresponds to just over 5 km per 1 000 inhabitants, while the same figure in the US and France are 13 and 15 km, respectively (SIKA, 2004-06-10).

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Road transportation in Russia is an increasingly problematic sector as car ownership has increased by about 7 – 10% per year in later years. As a result, traffic density has doubled in less than ten years while the construction of new roads has slowly declined and by 2004 it is far from keeping up with the rate of degradation of roads. Partly as a result of poor road conditions, with roads being under-repaired and with many incomplete construction projects, the number of accidents the roads have increased sharply, and the death toll is approaching 100 per day<sup>80</sup>. The reason behind this situation is both a lack of financing and the way the allocated funds have been put to use; often not in competition and most often without transparency, how funds are being used. In recent years allocations have gone down, in relation to GDP, from around 3% in 2000 to 1.5% in 2003, with a figure around 3-4% being the standard in the west (Duma, 2004-06-10).

The government launched a road-building program in late 2004 that will increase the funding for road building to previous levels. At the same time, privatisations in the construction sector and new working methods are hoped to improve the productivity of road building as well as that of maintenance projects (Ru-Gov, 2004-10-15). Allowing for private investments in the building of roads has also been suggested, but the generally low-income levels and low car ownership to international standards limits the road sections that could be of interest to investors to only a small fraction of the road net. Investments in road building would also be a very long-term investment for any investor, with currently unforeseeable legal risks and more questions than answers in the future.

To attract international interests concessions for road building must be very clearly defined and this has not yet been formulated in the legislation. It must clearly stipulate the period of both construction and guarantees for road usage, to give investors a fair chance to see a return on their money before the contract expires. One way used elsewhere is to sell established state toll roads to private investors, with the rents from such projects being channeled into the building of new state toll roads. Another alternative is to give a concession to investors who invest in road construction along with the government that includes land near the road that would compensate the investor for the costs. This alternative is probably only possible where there is a considerable demand for services from motorists, like gas, food, shopping, and entertainment. As referred above, by Prime Minister Fradkov, a motorway Moscow – St Petersburg – Helsinki could be a suitable pilot project for this kind of private - state joint partnership (Kommersant, 2004-10-07). This project of 735 km of motorway valued at over USD 6 bn was presented already some months earlier by the Federal Road Agency, for a construction start during 2004 or possibly 2005. No partnership

was indicated at the time and the estimated costs, for a road of relatively limited demand, would largely consume the totality of what is currently available in the road funds (SeaNews, 2004-05-26). Just weeks later, a somewhat surprising Chinese investors' group was presented, with an interest in the private 50% of this five year and USD 6 bn project (Kommersant, 2004-10-07 & MT, 2004-10-19).

The largest road investment in Russia in later years has been directed to the Far East in an attempt to, in the near future, make it possible to make the 10 000 km drive from the Pacific coast to the Baltic Sea, all year around. This is a project that already started in 1978, but came to a standstill in the 1980s, saw a restart it in the 1990s, but rampant corruption made it come to a halt again until 2002. The construction effort was again restarted and when President Putin inaugurated a large new trunk of road in March 2004, the ceremony also carried a strong symbolic meaning. It showed the intentions of the central government of holding together the vast country. Funding for this project has increased considerably, and at times has corresponded to near 25% of available investment resources. It has been estimated that spendings on the Trans Russia Road Project have reached USD 1.3 bn since the project began in 1978 (RRR, 2004-08-31). Much construction work has been assigned to the military, but as among other constructors, a considerable share of the money assigned for the project has been filtered away from its original purpose. A stable supporter in the road sector has been the EBRD, that has lent a total of USD 520 millions to two projects in the Russian road sector, for the St Petersburg ring road and this Trans Russia Road Project. The money has been made available on 15-year loan terms, with USD 130 millions in September 2003 and another USD 160 in July of 2004, despite the bank having had its project inspector killed in the Amur Oblast (EBRD, 2004-07-04). When there will be a ready road, in a few years time, the Trans Russia Road will be no less than a new window to the currently expanding Chinese market. Its use can particularly be expected to improve business conditions for small- and medium-size industries, in the service sector as well a trading of both inputs and products for local and external markets.

#### **Motor Industry:**

The volume of domestically produced cars in the Soviet Union and Russia has never been comparable to countries in the West, and neither has car ownership. In the years after the break-up of the Soviet Union, the industry first grew in importance with car ownership becoming only a question of money. However, already after a few years, it fell back again, after being hard hit by a continued increase in imports of new and second hand cars; from Europe in western Russia and from Japan in the Far East. In response to the pressure from domestic producers custom tariffs on imported cars have been changing regularly and has been lifted to near 100% of the original car value.

Ownership in Russia is on the rise from the late Soviet time level of around 50 /1000 inhabitants to around 80/1000 in 1998 to near 200/1000 in 2003<sup>81</sup>. The differences are considerable regionally as Moscow is said to have well over 250 while, e.g., the Far East is set around 150/1000. From industry sources it is projected that the car ownership level should have reached about 8 out of ten families by 2015, from under 3 currently.

Production in Russia stood at 1.1 million cars in 2003 and is not expected to increase dramatically, with 1.2 million being produced by 2010 (MOETD, 2004-08-04). During the first nine months of 2004, the domestic vehicle production has increased by 13%, over the year before, to 924 000 units. The volume of cars increased by 14%, to 735 000, or 80% of the total, with 140 000 being trucks and the remaining being a mix of other vehicles. The biggest producer of cars, AvtoVAZ, with its main brand name being LADA, is in the second half of 2004 producing at a yearly rate of 720 000 units (AvtoVAZ, 2004-09-14). Several of the domestic car manufacturers have attracted investments from international manufacturers and are currently producing not only their own brand as well as cars based on foreign design, but also foreign brands. Such examples are GAZ (Gorky Automotive Works, Volga model – in Nizhny Novgorod) has attracted capital from Italian Fiat, AvtoVAZ (Volga Automotive Works, Lada model - in Togliatti) has lined up with both GM and Korean Ssangyong to set up production facilities for SUVs, and UAZ (Ulyanovsk Automotive Works, jeep models in Ulyanovsk) is lining up with Nissan. A number of foreign producers have opened assembly lines in Russia under different arrangements, like BMW, Ford, GM, Hyundai, KIA, Opel, and Renault. These now produce or assemble imported, more or less completely knocked down (CKD) cars. An increasing percentage of the parts used for these foreign brands have been replaced by locally produced parts. The reason for this is twofold, prices are considerably lower for local parts and import taxes for parts are high. Sales of these are expanding rapidly and the Russian production of foreign brands reached beyond 140 000 during 2004, which was 140% up on 2003. With its current rate of increase, full year sales are estimated at around 145 000 well surpassing 10% of the total after having stood at 1% in 2002 (RJ, 2004-08-04). Although production of locally produced foreign cars expanded rapidly during 2004, it has still not reached more than 40% of foreign car imports, that was up by 80% during 2004 to 350 000 units. For 2005, it is expected that the increase will continue at a somewhat slower pace, or about 40% for the year, lifting the total above 500 000 (Vedomosti, 2005-01-18).

Joining forces with foreign producers has proved problematic, especially in the early years of transition, and many of the partnerships have been rumored for years before they came about. A new dimension of central control in this sector

was introduced by the Federal Antimonopoly Service in the spring of 2004. It ruled that a clause in the agreement between AvtoVAZ and GM that regulated the production volume of the Chevrolet Niva and the old Niva model is illegal and must be removed. The production of the old four-wheel-drive Niva model has been held back during the beginning of the year, to allow for larger sales of the more expensive Chevrolet Niva. This is an unusual twist to conventional market economic thinking, as AvtoVAZ is both main supplier of parts for the Chevrolet Niva model and JV-partner (Itar-Tass, 2004-05-26). Having sold its own make model for over 25 years it cannot be seen as unreasonable that the company deliberately reduces production.

Of the producers from the NEA region, Daewoo was an early mover to venture into Uzbekistan in 1993, and has much regretted this, while the production unit set up in Kaliningrad from 1999 has been more successful. KIA is already producing in Russia and has seen sales rise sharply and is upgrading plans to produce 55 000 units by 2006. Both Toyota and Nissan are planning to start production in Russia, initially based on CKD that will be shipped, with a gradual increase of sourcing from local parts' suppliers. This is the result of who both companies have seen yearly sales volumes develop positively, and saw sales jumping by near 50% and 70%, respectively, during 2004. Six of the seven top selling foreign brands for 2004 were from Korea and Japan, with Hyundai leading the list with sales of 51 000 during the year, up by 230% from 15 000 in 2003, and only 6 000 in 2002. Toyota came second, selling 44 000 (+40%), followed by Ford, selling 40 000 (+90%)<sup>82</sup>. Of these three both Hyundai and Ford assemble cars in Russia while Toyota and other NEA producers have been considering joining-up with a local producer. At least Toyota will build a factory of their own, which will be the first Japanese car factory build in Russia, at an estimated cost of USD 90 bn (Nihon Keizai, 2004-08-16). What for years have been among the most important export flow from Korea and Japan has not been new cars, but instead second hand cars. A trade so important that it is one of the issues that it is said to have held up Russia's bilateral agreements in preparation for the WTO with Japan and Korea. From Japan alone approximately 150 000 cars and additional some ten's of thousands has yearly been illegally exported to Russia in later years (JT, 2004-06-03).

Russia's main truck maker, GAZ, is in the second half of 2004, producing at a yearly rate of about 100 000 units (Itar-Tass, 2004-10-05). While GAZ mainly produces smaller distribution vans, also the most important heavy truck maker, Kamaz, with an over 30% share of heavy truck sales, i.e., >12 tons, increased production by 30% during H1 to near 14 000 (Kamaz, 2004-08-12). Also, a number of large foreign truck manufacturers have entered the Russian market, where both Scania and Volvo are currently assembling CKD units and are intending to increasingly source its parts locally.

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### **2.4.3. Water transport**

#### **Shipping**

At the time of the falling apart of the Soviet Union, ownership of high sea ships and shipping companies came to be split up among the new states. The city of registration for the different shipping companies came to serve as the base for the reorganization. The process came to result in some odd outcomes, as both the Ukraine and Latvia came to inherit large tanker fleets, as a result of the shipping lines that had formally been registered in Odessa and Ventspils, while neither country produces any oil for export. The same occurred also for the inland shipping where it was practically only Azerbaijan that, after the reorganization, had ships in the Caspian Sea. This was because the Caspian Shipping Company had been registered in Baku.

Although the shipping sector saw these kinds of outcomes from the split-up of Soviet time assets, ships are still both movable and sellable objects if they cannot be made use of, while ports are strongly bound to their geographical location. Ports are, in all respects, important as a vital point in the transport chain to handle international trade. Also in this line of business, the emergence of new borders came to produce a number of unforeseen situations. The centralized planning system of the Soviet Union had not foreseen that the cargo-generating areas in central Russia would ever be separated, by national borders, from the ports where the cargo were to be loaded. The ports in Odessa and Ventspils are again good examples as their oil terminals were both to experience the complications of relying on long distance sources for the cargo volumes they handled, and that later came to be greatly reduced.

During the 1990s the Russian Government long discussed the need for a fleet revival program, as the average age of ships in Russian fleet in the mid 1990s had reached well above 20 years. Newer ships, controlled by Russian companies, fly foreign flags to avoid the hefty state taxes. Much of the reason being that a ship build abroad and "*imported*" to Russia would have taxes corresponding to about 25% of its value levied. In 1992, about 800 merchant ships were registered under Russian flag, with a total of 10.6 million dwt. By mid-2004 the register had 200 ships with a total of 2.7 million dwt, with none of the 34 bigger ships built during the last five years flying a Russian flag (MinTrp, 2004-11-15). Since the turn of the century a fleet renewal program has been initiated, with the largest Russian based shipping company, with fully state owned Sovcomflot, as its main beneficiary. Sovcomflot has since 2000 through 2004 tripled its tanker fleet, to 45 ships, and during 2003 it carried 16% of the Russian oil export, or 10 mt out of 64 mt, to overseas markets. As a result the share of Russian foreign trade has been on a continuous decline. The continued orders placed for new ships by

especially the two major Russian shipping companies, in first of all Korea, but also in Japan and Russia, indicates that this expansion is far from over (Sovkomflot, 2004-08-15)<sup>83</sup>. Despite being state owned, the Moscow based Sovcomflot has during the last year started to register ships in Cyprus and Malta, and seen a sudden change in CEO to the former Minister of Transport, Sergey Frank (SSG, 2004-10-13). The second biggest shipping company, Novoship, on the other hand, was already the biggest Shipping Company in the Soviet Union under the same name. It was recreated after the break-up of the union, and has come to register most of its ships abroad. It has also set up an operational unit in London, which has taken over an increasing share of the duties from its former centre in Novorossiysk (Novoship, 2004-08-15). A new policy at Novoship, among others, could be under way, as after years of debate the ministry of transport has issued a proposal of a second, parallel, Russian ships register that would avoid the tax problem mentioned above (MinTrp, 2004-11-15). A register that in some year's time is hoped to attract some 750 ships to a total of 17 million dwt and to a value of USD 13 bn.

### **Inland waterways**

The Russian inland waterway system links the Black Sea with the Caspian Sea through Volga and Don, but can also be navigated north to reach both the Baltic Sea as well as the White Sea. Practically all major Russian rivers are navigable, but most larger rivers are floating north – south, and not west – east, as would have served the existing transport needs better. In the beginning of the 1990s Russia had about 100 000 km of navigable waterways, but how much out of that figure that can be used today is difficult to assess, but probably something in the range of 60 000 km. So far, the long awaited opening for internationally flagged vessels to use the inland waterways has still to happen. What limits the use of the vast waterway system, and its development, is the many years of general degradation, due to low levels of maintenance and non-fulfillment of the constant need for dredging.

### **Ports**

During Soviet years, the location for the big ports was chosen to fit the existing transport needs and infrastructure at the time. The cargo handling, that the ports were built for, was the type of cargo traded by the Soviet Union and not the kind of cargo, and the kind of cargo handling, that is a part of the 21<sup>st</sup> century. During recent years, Russia has been very active in constructing export outlets for its expanding oil production, attempting to meet a growing demand for transport and export capacity from oil producers. This ongoing construction effort has led to the building of new oil pipelines and export terminals, which geographically has focused on finding as favorable as possible locations, but restricted to the limited shoreline available inside Russia. An integrated part of the Russian transport strategy over the last few years has been to actively support its

domestic port sector through lower transport tariffs on the railways. When the destination has been a foreign port for an export consignment, sent by a Russian producer, the tariff has been considerably higher than to a domestic port. Of the handling in Russian ports, all commodities and a large share of other cargoes arrive by rail to the ports. Simultaneously, domestic ports had been expanding their handling capacity rapidly, in practically all cargo categories during these years. From 2005 this policy will be reversed. Rail prices for domestic cargoes will increase by 12%, and a strike among port workers against the decision has not made the railways change their decision (SSG, 2004-12-20).

With so much of the Russian export destined for the European market, it came natural to locate a new large port on the Baltic Sea in the Gulf of Finland. The Russian government has given priority to increase the capacity of the Primorsk terminal, which is to become at least as important for Russia's oil export as the terminal in Novorossiysk at the Black Sea. With access to only a short western coastline, the locations to choose from were few and the drawback of the Primorsk location is heavy ice conditions for many months of the year and it is located on the border of a nature reserve. The need for new port capacity for oil was enhanced when the Russian pipeline operator Transneft, in late 2002, decided to stop using the existing 30 mty Latvian terminal in Ventspils. Growth has also been exceptional at Primorsk and from having loaded its first ship during the last days of 2001, it has by the autumn of 2004, ahead of schedule, reached a capacity of 40 mty (Shipgaz, 2004-09-23). The continued expansion at the Primorsk terminal stops no short of a capacity of 60 mty by the end of 2005, and with also other terminals under construction, the Gulf of Finland is clearly becoming increasingly important to the Russian oil export.

Oil is, despite the enormous distances involved, not only being railed to ports in the Barents region, but also by ship along the Arctic coastline for reloading. Exports in the Barents Sea area are expected to triple from the 2.5 mt that was exported during 2003, to 6 mt in 2004 and up to 8 - 10 mty already during 2005. In late 2003, the VLCC tanker Belokamenka was anchored in Murmansk, on a 15-year charter, to serve as reloading storage for smaller tankers loading in Arkhangelsk or Vitino. The advantage is that the area from Murmansk and westward and is all-year ice-free conditions.

In the Far East, Russia has a long coastline on the Pacific Sea, but relatively few major ports. Out of what is possibly ten different alternatives, it is the three southernmost ones, Vladivostok, Vostochny, and Nakhodka that are the most important. Outside these, the Vanino / Sovjetskaja Gavan port and the new oil export terminal, from the new Sakhalin oil fields in De-Kastri, are the other with a larger share of international shipments. These ports are all highly dependent of



export cargos, often to some 70 – 80% of their turnover and a large share of this being deliveries from their mother companies. Ports in Petrosavodsk Kamtjatskij, Yushno Sakhalinsk and Magadan are important, but only so for domestic goods flows. In the four commercial ports in the region, the type of cargoes handled has widened with steel and containers as new and increasingly important products. Currently, a major share of the Russian coal export transits the Far East and the large coal terminal in Vostochny, where an export of 15 mty has been handled in later years. The main problem for the ports in the Far East are that they are located thousands of kilometers away from their main markets in central Siberia, and nearly two weeks away from Moscow by regular freight train – or over 9 000 km. This has not stopped large financial (coal- or steel-based) groups, generating large export volumes, from buying up controlling stakes in the largest ports in the Far East. Kuzbassrazrezugaol in Vostochny, NMK in Vladivostok, Evrazkholding in Nakhodka (both the commercial port and the fishing port); near the Korean border Universe Holding controls the port in Zaburino and the MDM Financial Group in the Poset port (RRR and Vladnews, various dates)<sup>84</sup>. The last two of these ports have been under discussions for a long-term lease from the Chinese side, as alternative port locations for Manchurian industry and mines are few, but the idea has been opposed by both the other ports and the regional authority. With the formal decision taken about a pipeline to the Far East the market will change dramatically. Inside the next five years, Nakhodka is to become the by far largest port, at the same time enhancing the strategic and economic importance of the whole region.

In later years, Russia has also made use of some oil terminals outside its borders to handle its exports, like the Lithuanian port of Klaipeda and its neighbor offshore terminal of Butinge, but also the Polish port of Gdansk. This use of foreign ports has been selective though, as the pipeline to the Latvian port of Ventspils has been taken out of use, while oil shipments by rail to both Ventspils and to Tallinn in Estonia have continued to expand. Practically the same pattern has been observed in the Ukrainian port of Odessa that previously served as big transit port served by pipeline.

The administration of ports in Russia was reorganized in 2003, in line with the reorganization of the Ministry of Transport and is now run under the Rosmorport organization. It was formed to separate surveillance and safety from the commercial aspects of the port operation, which now is administered by the 25 affiliates that Rosmorport have located in different ports. Currently, different fees for domestic users, or visiting ships in the ports, are paid to different operators under Rosmorport (SSG, 2004-10-04). The minister of Energy, Khristenko, has revealed plans to increase loading capacity over the medium-

term to 433 mt by 2010, with the pipeline capacity to have reached about 300 mt. By 2015, there should be a pipeline to both Murmansk and the Pacific Sea, initially with a capacity around 30 mt and should have reached some 80 mty by 2020 (RJ, 2004-11-26).

#### **2.4.4. Aviation**

For a country of the size of Russia, air transportation is of major importance. Large parts of the country have limited possibilities for land transport with air transport taking something well over 50% of long-range passenger transportation. At the stage of the break-up of the Soviet Union, the capacity of the aviation sector was at a comparable level with both the EU and the US. What has happened since was first of all the break-up of the monopoly Aeroflot into a lot of different companies. Out of these, few proved stable enough to survive the initial stages, as they were seldom very profitable. This led to a situation with a generally very low replacement level of an aging fleet of airplanes that already were of an old design. Sadly enough the result was numerous crashes involving Russian airlines, which further eroded the airline industry' already battered confidence among passengers. The few airlines that survived the hard years, and that have come out of the stagnation as reliable carriers, most often fly a fleet with a number of rented foreign-made planes. Out of over 200 carriers the three largest are Aeroflot (carrying 7.2 million passengers (5.9 in 2003), Siberia 3.9 (3.2) and Pulkovo with 2.8 (3.1) (Aeroflot, Siberia, Pulkovo, 2004-06-10 & 2005-01-18). The Russian airfreight market is still small, but quickly expanding. The two dominating devoted airlines are Volga-Dnepr and East Line (Volga-Dnepr, East Line, 2004-09-09). Among the conventional airlines, Aeroflot dominates with an expected volume of 140 000 tons in 2004, which would be up by 30% in 2003. About 40% of the 2004 volume was flown by its devoted four freight DC 10s (Aeroflot, 2004-11-29).

By decree, the President has initiated a merger between two of the biggest airlines, Pulkovo and Rossia that will take effect in the middle of 2005 (MT, 2004-09-03). The merger will not include the airport in St Petersburg with the same name, Pulkovo, and neither the part of the Rossia Airline that fly the president and the government. Together, the two will control a fleet of nearly 90 aircrafts, with Pulkovo contributing 45 and Rossia with about 40, nearly challenging Aeroflot's fleet size of 110. However, 30 planes will remain by Kremlin and as the two merge, it will be under the name of Rossia, despite being only ¼ the size of Pulkovo in passengers (MT, 2005-01-27). It is still Aeroflot that dominates the international market, carrying about 40% of all passengers while the domestic share has fallen to about 10%(Aeroflot, 2004-06-10). The Russian state still owns 51% in Aeroflot, a share that is scheduled for privatization during 2005.

During the previous political system, aviation was also heavily subsidized, which led to a high level of over usage as prices were set far below actual costs. In later years, when prices have had to cover costs somewhat more accurately, this has hit those far-off regions the hardest that are practically without alternative means of transportation. Other related problem areas in the aviation sector has been infrastructure at airports and runways as well as that for air traffic control.

During Soviet years, the importance paid to maintaining air connections among cities demanded an aviation industry of a considerable size. Based on the construction of military aircrafts, a civil aircraft industry was also developed in the 1950 and onwards that included well-recognized brands like Tupolev, Ilyushin, and Antonov. In line with the brutal fall in profitability in aviation, airplane manufacturing also came to a near standstill after the break-up of the Soviet Union. As in so many other industry sectors problems became worse by the simple fact that different branches of the same sector were now located in different countries and not only were they facing the difficulties of conflicting national interests, but also non payments for previous deliveries and currency problems coupled with large scale inflation. As the sector had been producing technically outdated products, it soon proved practically impossible to try to find an export market. After years of struggles, large scale downsizing, state mergers of the industry and a number of JV with large foreign manufacturers new planes are reentering the market with the brand names Tupolev, Ilyushin and Antonov still in production. Tupolev/Ilyushin aircrafts are still being produced in different civil aircraft versions for 100 – 200 passengers, while the Antonov company, now a Ukrainian one, has its focus on freight planes (Tupolev; Antonov, 2004-09-10).

## **2.5. Other**

### **2.5.1. Iron and steel**

During Soviet years, the expansion of steelmaking had a strong symbolic meaning, all from the early years of the revolution and the first economic five-year plans where iron and steel were the most important of the industrial sectors. Soviet steel production was, for decades, also the only to challenge US volumes and to ultimately surpass it for the first time in the beginning of the 1970s. The Soviet Union, and later the CIS, then remained the world's largest producers until after the break-up of the union when surpassed by Japan in 1993, but with production continuing decline until 1998. During Soviet years, about 60% of production came from producers in what today is Russia. Total

crude steel production for the three biggest producers in the former CIS, Russia, the Ukraine, and Kazakhstan in 2003 was 63 mt, 37 mt, and 5 mt respectively. Russian consumption during later years has been relatively stable around 20 mty, while production again started to increase about five years ago including 2004 (IISL, 2004-12-12). Average production costs for basic steel products in Russia are estimated not only to be by far the lowest among all major producer countries, but also among the lowest in the world; some 25% below Korea that have the second lowest (combined from IISI and WSD, various dates).

There are not only large and small-scale producers of steel in Russia, but also a number of in-house steel mills at some of the largest machine building and engineering companies. The ten biggest producers account for a very dominant share of rolled steel, but are less dominant in “flat” and “long” products<sup>85</sup>. Russia is also one of the relatively few countries that are fully self-sufficient in raw materials for its steel industry including coal and other metals. Since the beginning of transition the Russian steel industry has, based largely on price competitiveness, sharply increased its export to western markets, although the Russian steel exports have been met with strong resistance in many foreign markets with the setting of quotas and the introduction of other import restraints. As Russia is not a member of the WTO, this has been possible and had to be dealt with bilaterally in each individual case. Much of the export is directed towards Asia with the EU market and the US to follow in importance with rolled and flat products being the most important on the export side.

Russia’s biggest producer, EvrazHolding, produced near 14 mt of crude steel in 2003, with the MMK Group, producing about 11 mt, Severstal just under 10 mt, and with the number four producer, NLMK about 7 mt (EvrazHolding, MMK, Severstal, NLMK, various dates).

However, during the last three years, Russian consumption has increased faster than world demand, up by 14% in relation to 7% per year, with prices in the domestic market increasing by some 20% during H1 2004 (Metal Bulletin, 2004-08-12). Exports of steel products have increased in volume during the period, but even more so in value that has jumped by 70% to USD 6.7 bn from near 11 mt of products exported during the same period (Interfax, 2004-09-08). Russian producer, like most producers around the world, are profiting greatly from increasing demand and prices, with all the major producers having increased their profits many-folds over the last three years (Bloomberg, 2004-09-15). As an example, Severstal, Russia’s number three producer, had net profits from 2002 of USD 180 million, USD 590 in 2003 and with expectations of a profit of well beyond USD 1 bn in 2004, with the other majors posting earning in the same category (Severstal, 2004-10-29). These numbers have helped the industry to

reduce financing costs further through greatly improved credit ratings from international institutes. Also the operation has improved greatly over the years, which the inclusion of Severstal as number two, rising from number five in just one year, on the listing of the world's best steel companies for 2003 indicate (WSD, 2004-06-21).

Inside the industry, the increasing wealth has fuelled speculations that the future will include large-scale international expansion. Initiated by the Severstal acquisition of the US steel maker, Rouge Industries, for USD 286 million during early 2004. The Russian steel industry has a strong competitive edge in low costs and strong demand from an economy showing strong growth figures. It also attracts a considerable foreign interest as the state being set to privatize its 24% share in the MMK Company during 2005. The future in the sector is somewhat contradictory, as Yevraz has stated to cut production due to slightly falling prices and demand, after having stated increases just months before. At the same time, the company is investing USD 60 millions in Novokuznetsk to increase production from 0.9 to 1.5 mt (Bloomberg, 2004-06-15). Examples indicate that any deeper understanding is not really possible without a deeper knowledge of the industry in question and relatively detailed information about prices and production<sup>86</sup>.

Other big mineral extractors, and metal producers, are Norilsk Nickel near monopolist for both nickel and cobalt while producing over 50% of the copper. It is also world leader in the production of the rare earth, and high value, metals like palladium and platinum. Norilsk Nickel is another company in the mining sector that is expanding internationally by its takeover of a 20% share in South African Gold Fields Ltd. for USD 1.2 bn in March 2004 (Norilsk, 2004-07-01). A deal that has been discussed to be as much as way to secure foreign assets for its owners as it is a conventional FDI. Polimetall is another of Russia's largest miners of gold, 6.6 ton, up by 60% over 2003, and 537 tons of silver (+47%), placing them among the world's top-ten (Canadianminingjournal, 2004-08-31 & Itar Tass, 2005-01-20).

With energy costs making up 30 – 40% of the final price of aluminum, it is not surprising that Russia is a world power in the refining of aluminum. That is despite the fact that Russian smelters so far have had to import most of the raw material in the form of alumina (aluminum oxide) used in the production. As energy consumption in the electrolytic process is so large, the location of the two biggest smelters in the country, at Krasnoyarsk and Bratsk, with the latter being the largest smelter in the world are not surprising. Both are to be found near two of Russia's biggest water power stations, which well offset the fact that they are found 5 000 km away from the nearest port. Just these two units turned out

about 1 mt in 2003. During the year, RUSAL produced about 2.6 mt out of the Russian production of just over 3.5 mt (RUSAL, 2004-08-01). As the domestic consumption is less than 10% of the production volume, 90% is being exported, making Russia the world's leading exporter, only being behind China in production volume (Canadianminingjournal, 2004-09-23). Restructuring in this line of business has been dramatic and the now dominating industrial group, RUSAL, produces 75% of the national production and 10% of the world's primary aluminum. With aluminum being a sensitive industry, Rusal's attempt to sell off two of its less productive units, in Samara and Belaya Kalitva to the world's largest producer, Alcoa, has long been awaited official approval.

The second largest among Russian aluminum producer is Siberian Ural Aluminium (SUAL) with an output of about 900 000 tons for 2003 with over 80% of this exported (SUAL, 2004-08-01). SUAL also holds Russia's largest bauxite finding, from which only 1 million tons were extracted during 2003 at a smaller bauxite mine in Sredny-Timan in the Republic of Komi, and shipped to the nearby alumina refinery, out of near 4 mt extracted in total. To multiply the mining volume, SUAL has been trying to attract the interest of numerous overseas aluminum producers and miners for a joint investment project in the range of USD 2 bn, but with little success so far (SUAL, 2004-08-17). On the other hand, SUAL has had success in expanding in the local in taking over Russia's smallest smelter in Volkhov and the Pikalyovo alumina refinery from Metallurg (Reuters, 2004-10-05).

In titanium mining the worlds largest mining company, BHP Billiton, has been named by LUKoil as possible partner in developing Europe's largest titanium finding, at Yaregskaya oil and titanium field in the Komi republic. A combined field that is estimated to hold about 640 mt of ore, but also 31 mt of oil. It was only after a similar offer to Russia's only titanium producers, Verkhnyaya Salda Metallurgical Production Association, had been turned down that Billiton was invited. A partner is needed to build a processing mill and to market the output (Vedomosti, 2004-10-28).

For the first time ever, Russia during 2004 released official figures concerning its output, exports, and imports of diamonds, and the numbers are not as huge as has sometimes been rumored in the past. During 2003, the production value of diamonds reached USD 1.7 bn (33 million carats), and after a slight increase during H1 2004, the value reached USD 948 million (18 million carats) (RJ, 2004-12- 23). During 2003, the export of rough industrial diamonds corresponded to about half the total value.

At times when prices are high, mining could not only be a highly profitable business, but it is also a considerable pollutant and is seldom a welcomed newcomer in not well-established exploration areas. It is also a line of business that, in its search for new findings, is eager to overcome administrative hurdles. An example of this in the NEA region could be the large-scale corruption scandal that erupted inside mineral resource extraction in the Khabarovsk Krai. The head of the Department of Natural Resources and Environment Preservation in the Krai was in the beginning of 2004, arrested on charges of extortion and the taking of bribes. This has led to cancellations by some 60 awarded contracts for mineral exploration in the Krai has, after having been re-examined in Moscow (Interfax, 2004-02-22).

### **2.5.2. Forest**

Despite being the country that holds the by far largest forest reserves of the world, the Russian forest industry remains greatly underdeveloped. The margin for improvements is high as the industry has, especially since the break-up of the Soviet Union, concentrated on supplying raw materials to neighboring markets and on producing basic products for the domestic market. It has lacked investments and has not been able to make use of its potential for value-added production for sales domestically or internationally. During Soviet years, attempts were made to upgrade production in the sector by considerable investments, which included bringing in foreign equipment on a large scale. Investments were mainly directed towards large paper and pulp plants, with several of these intended to export parts of the production. However, forest-related activities remains an industry, which will offer substantial long-term investment opportunities for many years to come. The abundance of natural resources available, being international cost competitive, with increasing domestic demand, will for a long time provide a good base to transform the sector. The geographical spread of the sector can make it become an important growth sector in the economy, especially in northern and peripheral areas with few other mineral resources.

The sector has, over the transition years, been one of the least centrally controlled and also one where corruption, e.g. to obtain felling permissions, has been wide spread. This has also left its mark on production statistics that can be assumed to be even less reliable here than in nearly any other sector.

Since the sharp devaluation of the Ruble in 1998, made Russian wood production, as well as all other products, has even more price competitive than before. Exports have largely been on the increase since then. The control over the Russian forest has, during transition, been legally based at the regional level,

and to improve cohesion, a new forest code was adapted during the spring of 2004. The new code is expected to generate much greater federal control of Russian forest resources. Minister Gref hopes that this will increase foreign investments in the sector as well as reducing the export of logs and instead promote the production of processed forest products, as a way to use available resources more efficiently. The government also wants to improve the timber-processing sector and by increasing taxation on the export of unprocessed products, it hopes to support the value-added side of production (MOEDT, 2004-03-10). The new code will make it possible to sign extended lease terms for forest up to 49 years. Currently, the maximum is five years, and it is hoped that the longer term of lease will make investors put at longer-term perspective on their ownership. Rights will first of all be sold (that is, for lease) at auctions, which critics fear, will lead to that only rich foreign companies will win tenders; as what happened with fishing rights when a similar reform was made. Therefore, there is a growing concern in forest-rich regions, like Karelia, that foreign owners that win tenders will not accept any social responsibility for exposed smaller communities in forest regions (Karelia, 2004-10-15). At the same time it is not very likely that many foreign bids will be given at auctions if the most important in the bid is how much money that will be set aside for local infrastructure and initiatives in the social sphere.

Alongside energy and marine products Russian forest products are an important export products from especially the Far East to countries in NEA. It is also a product category that carries a considerable potential, as the surrounding markets are all large consumers with a limited domestic supply. Timber and other forms of processed products are important transport generators in each step of its elaboration with the export reaching over 10 mt in 2004. Russia holds about 22% of the world's standing timber and is increasingly serving as a growing source of low-cost timber and wood fiber source for other parts of the world.



## **3. Japan**

### **3.1. Introduction to Japan<sup>87</sup>**

From about 1950 on to the first oil crises in 1973 the Japanese economy was subject to a lasting positive trend, with an average GDP growth of 9.7% to show for it. The years that followed did not prove as predictable, as strings of good years were mixed with lows, but still maintaining an average GDP growth of 3.7% over the next 20 years. However, by the late 1970s and during the 1980s Japan was monitored as something like the model of economic achievement by countries in the west. Something that was to change with the stagnation period that set in around 1990. As a result Japan has instead come to be looked upon as an example of near constant stagnation over the last 15 years. Since 1992 Japan has only registered GDP growth of above 2% during 1996 and 2000, but actually only one negative year, 1998. Although the GDP growth figures during the 21<sup>st</sup> century cannot be compared with previous decades development, things have indeed changed for the better. Japan's economic growth figures for 2003 became the best in 13 years, indicating an export-led recovery growth of 6.4% and the most promising economic recovery since the big downturn in the early 1990s. For 2003, Japan outstripped growth in the US and by a large margin that of the EU. At the same time Japan's current-account and its trade surpluses have grown steadily since late 2003 until the end of 2004.

#### **3.1.1. The Japanese Economy**

The positive development of the Japanese economy since the beginning of 2004 has been better than expected and the annual growth of GDP for the fiscal year is, by the Bank of Japan (BOJ), expected to reach 3 – 3.5%<sup>88</sup>. This is based on the continued strong growth in exports to China and the United States, and hopes that the positive effects should come to spread into the national economy (BOJ, 2004-04-29). During 2004 the positive economic trend has proved stable enough to make also international institutions like the IMF upgrade predictions for the full year, and substantially so, from 3.4% to 4.5% (Kyodo, 2004-08-12). Not only was the forecast for 2004 the highest given in ten years, but also the forecast for 2005 was upgraded from 1.9% to 2.4%, as the economic problems seemed have eased. The clearly lower figures for 2005 comes from the fact that trade with especially China is expected to slowdown to a less booming level which will also moderate the Japanese export expansion. The Japanese economy has in real terms continued to expand during most of 2004, but at a falling rate as the first quarter GDP was up 1.4%, second 0.3% and with only a 0.2% growth during the

third quarter (METI, 2004-12-08). In the autumn of 2004, a new method to calculate the GDP was introduced, said to better reflect the effects of inflation and deflation. Instead the economic progress during the three quarters in real terms came out as 0.3%, -0.6%, 0.1% respectively (PMOJ, 2004-12-24).

During 2004, the government has constantly kept issuing positive assessments of the economy, but has also stayed cautiously about the effects on the economy from the upward trend in raw material prices. With companies having seen the positive effects of the positive economy, clear indications are still to be seen from that this has spread into the private sector. So far, neither the economic upturn nor the interaction between these two sectors of the economy has been as strong as could have been expected. Companies have generally been able to increase profits resulting in slightly higher share prices since the year before. At the same time, both investments and wholesale prizes increased, while unemployment has slowly started to fall, to a six-year low of 4.7%, which are all factors that should indicate an expanding economy. The 1.3% rise in wholesale prices was the first in over six years, but consumer prices still fell by 0.1% during 2004 (PMOJ, 2005-01-28). By mid 2004 it was expected that the pace of industrial production growth would gradually slow down, with exports to remain steady (METI, 2004-07-29). Seen to the full year figure, that is exactly what came to happen. The production increase for the year came to 5.5%, while during Q4 the rise in industrial production came to a very modest 0.8% (PMOJ, 2005-01-28). Despite several seemingly positive signs of a strong GDP development, the positive trend has slowed and deflation had by early 2005 not been fully overcome.

Given the recent upward trend in world commodity prices, it can be expected that also consumer prices will go up, but prices of intermediary products have remained stable, which can also indicate a fall in profits for business. Such effects of the rising prices have been absorbed in the business sector is shown by the fact that average wholesale prices in Japan did not rise during one single month from June 2000 until the next rise was registered in April 2004 (BOJ, 2004-05-13). During 2004, it is prices for energy, metals and coal that lift the average having gone up by about 10 - 15%, while electronic products, phones, instruments and machinery have all seen falling prices during the year. Since 1995, with exception for 1997 - 1998, deflation has been a constant phenomenon in the Japanese economy. One of the most important long term goals of the government has been to break the long term deflationary pressure on the economy and rising wholesale prices could be a sign that this is about to soon happen. Possibly so, but the positive effects of the GDP growth still has not spread enough to have benefited the small- and medium-sized companies and regional economies. The first to profit from the positive development has been

the large conglomerates and the ones focused on exports, which has come to focus the improvements to the Inland Sea region. This very same region, along the inland sea, has shouldered much of the hardship during the long years of economic slowdown.

Confidence for a stable recovery is not only underpinned by strong demand from export markets, like China, but also strong domestic sales of digital electronic products. With a third straight quarter of sales gains, ending in June 2004, this became the longest streak since a seven-quarter increase that ended in September 2001. Household spending in Japan has been on a slow upward trend during 2004, with families spending a monthly average of 306 000 (USD 2 800). In the Japanese GDP, the household spending figure is of utmost importance as it makes up some 55% of the total (MOIAC, 2004-09-04). The upward trend has remained, but with a stagnating industrial production and with flat exports, and has resulted in a falling business confidence also among large manufacturer (BOJ, 2004-12-17). As a result major business leaders are expecting 2005 to become a year similar in development to 2004, which is a tendency that can probably be attributed to a record price for oil and the increasing value of the Yen (Kyodo, 2005-01-03).

There is apparently a widespread skepticism between the rather convincing macroeconomic data (in its first version) presented by the government and how the general public and the retail business see the situation. Increased sales of a product does not necessarily mean increased revenues if prices are falling, or have been lowered, as sales are equal to unit price times the number of units sold. Currently it is also frequently so that if products increase in capacity by 50%, which currently happens at a rapid pace for mobile telephones, computers and cameras, while prices remains unchanged, the figures become distorted. This is, at least theoretically, a 50% cut in the price of the product. In the different sectors of the economy, it is increasing unlikely, with ever-shorter business and production cycles, that all companies will face the same development, although the sector at large is developing well. During 2004, the price of both laptop and desktop computers in Japan fell by near 30% and in the Tokyo area prices in December dropped for the 63<sup>rd</sup> consecutive month, down by 0.5%, indicating a continuation of the trend of falling prices (JT, 2005-01-29). The state also has to take side in the development and decide where to use its resources, if it should invest in supporting the currency value or if the available resources should go to infrastructure projects. Factors outside the domestic market have also come to more directly and increasingly affect the development rapidly, with oil prices being a good example. Out of the final price of a product, the price for the raw materials being used is becoming an ever-smaller part, and Japanese manufacturers have so far been able to absorb these costs without

raising final prices. Another insecurity for the future is the interest rates that have been kept on a historically low level over the last few years. If, for the near future, interest rates remain low, then it is not unlikely that the current deflation could continue well into 2005.

When an economy, like in Japan over the last few years, is faced with falling prices an important factor in the discussion is the GDP deflator. It is an indicator that is derived from price fluctuations during the period, and has, in the case of Japan been on the negative side since 1998. It is used to recalculate the nominal GDP to real GDP, increasing the value in an economy facing deflation and reducing it for an economy facing inflation.

In the same way as the economy in Japan has showed low, or negative growth, the stock market has also developed poorly, but has nevertheless shown an increase of 10% over its August 2003 index. Apart from general pessimism, other culprits behind the slow stock development over later years is due to that corporate pension funds have been selling to dismantle cross holdings in the financial sector. At the same time private funds have to sell shares to be able to return to the state the assets from the pension funds they have managed on behalf of the government (JT, 2004-05-01). However, the relatively modest improvement in stock values over the last year is surprising as company pre-tax profits for fiscal 2003, on the first section of the stock exchange reached the highest level ever. Profits surpassed 20 trillion (USD 180 bn) and broke the 2000 record of 18 trillion (TSE, 2004-04-20). As in 2000, its large domestic sales of digital equipment that is said to not only have lifted profits, but also increased export along with cuts in costs and staff at many companies have boosted profits.

In the state budget for 2005, worth 82 trillion, the government has made an *"utmost effort to cut costs"* by marginally reducing other outlays and while seeing debt servicing costs increase (PMOJ, 2004-12-20). To make up for falling revenues, there will be a rolling back of a tax-break given in 1999 to lift consumption and a rise in the VAT, from its present 5%, has also been discussed to increase the 44 trillion-tax intake. Still, there will be a shortfall of near 34 trillion that will be financed by new bonds, which is over 40% of the budget. In the Prime Minister's long-term plan, tax intake will cover expenditure, except for debt servicing by the early part of next decade. It can only be hoped that the country will not again enter into a stage of deflation. However, Japan cannot be to overoptimistic either about its economy, as it perhaps was in the late 1980's. In the medium term there are important reforms to the state that should be carried through. Reforms that have been initiated are on the pension system and to local governance. Additionally, the privatization plan prescribed, among

other objects, includes the controversial privatization of the state Post beginning from 2007. The Post is seen as important due the fact that it will make it possible to dissolve huge postal funds worth 350 trillion (USD 3.4 trillion) from both public and private sources. Seen in the light of an aging population and a shrinking working population, a reform to the social welfare system, already absorbing 25% of the deficit state budget, is another increasingly urgent reform area.

## **Investments**

### **Domestic Investments**

The share held by the state in investments has fallen during later years, as a result of a deliberate government plan to create economic structures that are less dependent on state and public sector demand. At the same time domestic lending from banks to corporate customers has been on a continued decline for 83 months, from January 1998 to November 2004. Indicating that companies are first of all reducing their debts, at the same time as investments could have been even bigger (BOJ, 2004-12-08). Generally, Japanese companies are willing to invest, but something of a two tier system has developed where more companies are cash-rich after some good years while many are still burdened by debts (PMOJ, 2004-11-03). Japanese companies invest the correspondence of some 15% GDP in corporate plants and equipment in 2003, compared to about 10% in the US. The willingness to invest is underscored by the fact that during 2004, companies placed the largest orders for machine tools since 1990, up by 45% over 2003, to upgrade production facilities. In a situation with large investments and debts in a market where consumption is stagnant, companies have few other alternatives than to export.

### **Outbound Investments**

Already during the 1980s, Japanese manufacturing companies started to move out parts of its production to the *"tiger economies"* that were booming at the time. This had a relatively limited effect on the Japanese economy as a whole, and it possibly strengthened the economy, as the domestic market remained well protected from imports at the time. Still, it has been Europe that has remained the most important destination for Japanese overseas FDIs over the last ten years, being on a level of twice the amounts invested in other Asian economies. The second most important geographical area is North America that some years has nearly received investments on par with Europe (WebJapan, 2005-01-31)

During fiscal 2003 the Central Bank's currency interventions absorbed much of the available funds that alternatively could have been used for investments abroad. At the same time, the low value of the Yen resulted in increased export.

In evaluations made by ministries it has been shown that domestic companies increasingly view China more as a market than just as a low cost production base (METI and MEXT, 2004-09-12). Although many Japanese firms have shifted much of their production bases to China and other low cost labor nations, they have at the same time proved reluctant to allow their latest technology to move out. Japanese companies have generally protected their advanced technology by keeping their development and production processes at their home base, in relative secrecy. What is more standard technology has been widely passed on to overseas facilities, but this is not the case for state-of-the-art technology, for this new Japanese production facilities have been build by many of the top electronic producers over the last few years (METI, 2004-08-12). The focus of production for these new installations has been high-tech products and automation, to compensate for labor costs.

Being the home country for a number of important outbound investors the transfer of profits and other payments have come to be of increasing importance to Japan. To a large extent, these changes were practically impossible to foresee some 20 years ago. As a result, Japan has taken the initiative to revise existing tax agreements with its Asian neighbours, with the hope that lower costs will increase business contacts. The proposal was introduced at the meeting of ministers of finance at the ASEAN +3 meeting in Korea in May 2004 (METI, JT & KT, 2004-05-12 – 13). It will probably take quite some time to first convince other countries of the necessity of new agreements, and then negotiate such deals. The plan is based on the new tax agreement, effective March 2004, with the US. It is hoped that the tax on dividends should not only be reduced to 5% in the country where the money was earned, but also to cut taxes on royalties paid abroad. Both these profit transfers and royalties are important income earners for Japan.

### **Banking and monetary policies**

In the 2000s, the Government under Koizumi has worked hard, and relatively successfully, to ease the burden of bad loans that has been restraining the Japanese banking sector. A policy that has been supported by the Central Bank that since March 2001 has kept the cost for borrowing money at almost zero, with the aim of overcoming stagnation and help the economy to take off. The BOJ has no intention to change its policy until clear signs exist that consumer prices have clearly started to pick-up, after its six continuous years of decline. With the last quarter of 2003 and the first of 2004 having displayed good growth figures, with the following two have been somewhat stagnant, but still not positive enough to indicate the arrival of a more sustainable growth. In Japan the consumer spendings is an important indicator that has been increasing steadily, although very slowly, but despite this prices are likely to remain stable, or even decline, largely as a result of productivity improvements (BOJ, 2004-09-09).

## **Russia and North East Asia - in times of globalization**

For the full fiscal 2003, Japan's current-account surplus reached a record of 17 trillion yen, which was a 29% increase and even surpassing the 1998 record increase of 13% (METI, 2004-05-17). The surplus is, first of all, a product of strong goods exports, with merchandise trade generating a surplus of 13 trillion, and a fall in the service deficit by about 60% to 1.5 trillion<sup>89</sup>. The capital side of the balance resulted in a surplus of almost 21 trillion, up from a deficit of 5 trillion in 2002. The difference was largely generated by currency interventions made by the Central Bank and has served as a base for the build-up of the currency reserve. During 2004, the surplus of the current account has continued to grow and by the end of September increased a further 13%, to above 19 trillion yen (ibid., 2004-11-10).

The Yen has seen a slow rise over the last years and has had its three-and-a-half-year high around 105, although it has been held back by considerable Bank of Japan interventions to keep down the value<sup>90</sup>. The Yen rate is a big blow to exporters as a stronger Yen makes their goods more expensive in world markets, which is confirmed by the employers union: "*Our biggest worry is the Yen*" (Nippon Keidanren, 2004-05-15). Despite China's strong economic growth in recent years, the value of the Yuan has decreased against the Yen by 8 – 10%, contrary to economic theories, over the past year from mid-2003. The values of all the major currencies, like the Yen, the Dollar and the Euro are flexible and determined by market transactions, although some monetary authorities have intervened in attempts to adjust the values set by the market. The Bank of Japan, in particular, has intervened stubbornly, and has relatively successfully offset a larger rise in the Yen value in relation to the US dollar, during 2003. As a result of the monetary interventions to maintain a stable value of its currency Japan's foreign-exchange reserves has been growing and had, by the end of October 2004, reached USD 840 bn; which is the highest level ever (MOF, 2004-12-07). The largest holding in the reserve is US Treasury Bills that have been bought up during the latest intervention period that lasted during the whole of 2003 through the first quarter of 2004. This line of action from the Japanese side has been a considerable contribution to the US burden of financing its current-account deficit. This is something that has been shouldered actively by several of the governments in Asia who have seen this as being the most secure, but not necessarily the best, investment. The need for these kinds of investments have, like in the case of Japan, Korea, Taiwan and others, come from a booming foreign-exchange reserve that has been accumulated as a result of trade surpluses and the currency market interventions. In the latter part of 2004 the value of the Yen has again started to rise and by early 2005, the exchange rate reached a five-year high of almost 101 Yen to the Dollar, with no intervention from the Bank of Japan (JT and Bloomberg, 2004-11-19 – 12-03). It could well be so that this trend continues further as the gigantic US current account deficit, as

well as an increasing trade deficit, and costs related to the Iraq war, have generated a downward pressure on the US dollar<sup>91</sup>. At the same time, China has not changed its currency policy, and maintains a voluntary peg to the US dollar, bringing profits to Japanese companies that have shifted their manufacturing base to China. That refers also to domestic companies that buy inputs from Chinese suppliers. Still, it is not necessarily so that shifts in the domestic currency rates, even between trade partners, will affect traders as prices can well be set in a neutral currency.

The currency policy adopted by the Bank of Japan, aiming to maintain a low value of the Yen has led to an increasing national debt. To maintain the low Yen has cost the Japanese Government a lot of money. The outstanding debt of the Japanese government totaled a record-high 670 trillion (USD 6 trillion) at the end of 2003. A total that includes government bonds, non-bond borrowing and short-term debt financing bills, a debt that now demands large interest payments. According the financial plan for fiscal 2004 the debt is expected to surpass 700 trillion during the year, reaching over 150% of GDP; highest among all OECD members (MOF, 2004-03-25 & OECD, 2005-01-20)<sup>92</sup>. The cost for servicing the debt for fiscal 2005 is, by the Ministry of Finance, expected to reach beyond 20 trillion, or about 20% of the state budget (BOJ, 2004-08-27).

Profitable companies and continued FDIs by Japanese companies have led to that the net value of foreign assets held by Japan, reaching 173 trillion (USD 1.6 trillion) at the end of 2003. Although the net value fell by 1.4% from 2002, it remains the highest in the world for the thirteenth consecutive year and more than three times the net assets held of the number two, Switzerland (BOJ, 2004-04-21). The slight fall in value can be attributed to the increased Japanese debt, more stocks held by foreigners, which, additionally, have increased in value during the year at the same time as the appreciation of the Yen has eroded the value of foreign assets. Total overseas assets stood at 385 trillion (USD 3.5 trillion), which was up by over 5%, while the external debt increased by near 12% to 213 trillion (USD 1.9 trillion) during 2003 (BOJ, 2004-05-21).

Japan is not the most active nation in the discussions concerning the eventual establishment of an Asian currency, but an established cooperation forum already exist in the currency field between countries in East Asia. At the yearly meeting between Central Banks in East Asia and Oceania in 2004, it was decided to set up a fund that will invest in government bonds, nominated in local currencies. This was aimed as a follow up on a mutual fund of similar size, USD 1 bn, which invested in Asian government bonds issued in USD. The intention of the two funds is to keep available currency flows in the Asian market, instead of making money initially leave the region and then coming back in the form of



currency reserves at a higher cost (BOJ, 2004-05-02). A long term goal for such holdings, if they can grow many times larger, is to stabilize money flows in the region and hopefully reducing the risk of a new crises, similar to what happened in 1997 – 98. The same kind of initiatives, attempting to find ways of creating and expanding an Asian bond market, has also been taken inside the ASEAN + 3 framework (ASEAN, 2004-08-10).

One of the factors that have made the Japanese economic recession so difficult to overcome, has been the huge non-performing loans that have accumulated in the banking system at the outbreak of the crises. In one case, Resona Holdings, the state came in and nationalized the bank, injecting about USD 16 bn of new capital. Because of the accounting system used, transparency has been lacking and the actual size of non-performing loans for the different banks have been difficult, if not impossible to assess, with figures between 10 – 50% of GDP having been circulating (Economist, 2004-07-16). Through its Deposit Insurance Corporation, the state has been supportive in reducing this debt, and has since 1999, bought non-performing loans from private banks to a face value of near 4 trillions, at a cost of 340 billions (BOJ, 2005-01-06). Much as a result of this support from the banking sector has gradually been able to reduce the burden from the non-performing loans, from over 8% of the loan stock or 41 trillion, at its worst in March 2003, to the end of September 2004 figure of 5% or 23 trillion. As late as June 2004 the number four in size, UFJ, itself created by a merger of three banks in 2001, after continued deficits has been given a green light to merge with the number three in size, Mitsubishi-Tokyo, creating not only Japan's biggest, but also the world's biggest bank measured in assets, USD 1.7 trillion. By a margin surpassing the two what was previously bigger, Mizuho with USD 1.3 trillion and the number two Sumitomi-Mitsui with USD 0.9 trillion in assets. The merger will make the now state-owned bank Resona move down to fourth, in terms of size. The sector at least looks sure to have emerged from some years where many banks had problems to survive, into a stage where practically all banks during H1 2004 were profitable again (Zenginkyo, 2004-12-27).

### **Employment**

The Japanese workforce, of people registered as workers by companies, is approximately 43 million, with an additional 4 million being readily available on the labor market, out of a population of 128 million.

Recovery from the long economic deflation period has been considerably slower when it comes to employment and consumption in the household sector, than what is indicated by the GDP growth figures. Unemployment has been going down from its peak at 5.5% to a mid-2004 level of 4.6% and ending the year at

4.4%, which is a very positive sign. Despite the fact that 2.7 million were registered as unemployed, it is still the lowest figure in six years (MHLW, 2005-01-28). Male unemployment stood at 4.6% and female at 4.2%, with the number of people forced into unemployment due to bankruptcy or restructuring fell by 15%. A problem inside the trend of increasing employment is that most of the new jobs registered are not only less qualified and low paid, but are often also part-time jobs. During Q1 2004, as many as 15.5 million were non-regular workers, i.e., employed on short-term contracts, employed by temporary staff agencies or on part-time. In all, this group makes up 31% of the workforce and 53% of female employment (ibid., 2004-07-30). These workers often work near full time but get considerably less benefits than full time employees. In a labor market where wage increases have been marginal in later years, but with bonuses in the 1 – 2.5 million range being given at larger companies, it becomes increasingly important to find a fixed position by a company.

According to official statistics, unemployment for the youngest aged group, 15 – 25, averaged 8.3% in December 2004 (9% in 2003), but clearly lower for the 25 – 34 group, which had 5% (6%). Also during 2004, over 2 million younger employees, up by near 4% during the year, in the 15 – 34 age bracket, were getting along on part-time jobs only. Additionally, among the unemployed in the wider age bracket, 520 000 were estimated who were neither trying to find work, nor receiving higher education during the year (MHLW, 2004-09-09). Especially the latter group, which indicates that there is a need for a strict awareness to enhance this groups capabilities and enthusiasm for the future. If not so, this category runs the risk of slowly turning into a considerable societal problem. A positive figure by the end of 2004 was that there were 94 jobs on offer per 100 job seekers, up from the 2003 value of 83 (ibid., 2005-01-28).

In an effort to contribute to reducing costs, the government froze wages for civil servants, and slightly started to cut wages and/or bonuses in 1997. With differences now having been reduced among state wages and the private sector no reductions will be made during 2004. A recommendation that is expected to be followed through also by local governments. Still, yearly income for a state administrative worker, including bonuses, stood at 6.3 million (USD 57 000; bonuses are generally 2 - 4 months salary) at the end of 2003 (PMOJ, 2004-08-06). Average monthly earnings for Japanese employees, by the end of July 2004, stood at 392 000 (USD 43 000/year), with regular workers earning an average of 280 000 (USD 30 000/year). An average worker's household during 2004 spent 530 000, indicating an increase of 1% over 2003. Domestic spending is an important factor in the Japanese GDP, but still the available share of incomes is lower in Japan than in other G5 economies; about 60% and 70%, respectively (MOF, 2004-07-02). The average number of hours per month worked by

employees at the end of July totaled 155 hours, a decrease by 0.6% over the year before. Non scheduled extra hours worked inside manufacturing totaled 16 hours per month, which was a 2% increase (MHLW, 2004-09-15 & 2005-01-28).

The consumer confidence index in Japan, that among other factors also includes the respondents, confidence in employment that stood at its highest in over 13 years, since July 1991, in August 2004. This indicates that consumers feel confident for the near future both in employment and when it comes to prices and openings for own spending (PMOJ, 2004-09-13). This confidence that resulted in a 1.5% increase in household spending during 2004, combined with record corporate earnings, and increased employment, should lead to a positive circle (MHLW, 2005-01-28). Although this development has still to really take off as the GDP late in the year showed a clear fall in growth.

The entry of foreign workers in Japan is regulated by a policy adopted in 1999 that allows for workers with professional skills to apply for jobs, but with strong restrictions for unqualified workers. This has led to that estimations set the number of legal foreign workers in Japan to some 200 000 (JT, 2004-08-23). Most of these work in construction, agriculture, forestry and fishing, i.e., doing relatively unqualified work. There are training schedules in place for workers that has introduced some 60 000 foreigners since it was started up in 1990. There are still fears that the work permit system is exploited by many companies to obtain low-cost labor this way, and not the high skilled workers originally intended (MHLW, 2004-06-16). In 2003 the share of foreign workers in the Japanese market was just 1%, compared to the US and Germany where foreigners constitute 10% and 8%, respectively (JT, 2004-08-23).

Seen from the outside, Japan would probably find use for foreign workers as it is has an aging population. A record 25 million Japanese were aged over 65, or just over 20% of the population in September 2004 (PMOJ, 2004-09-19). The group over 65 is 17% of all men and 22% of all female. But worse is to come as it is estimated that the share over 65 will continue to grow and to have passed 25% inside the next 10 years, with the share having grow practically uninterrupted since 1950. At the same time the youngest age group is getting smaller as the nativity rate in Japan in 2003 was below 1.3/woman (WebJapan, 2005-01-31).

### **Other related issues in brief**

According to a Government White Paper on the Economy for 2004, the positive effects of the globalization process have not been taken full advantage of by Japan and its business society. So far Japan has only acted as a receiver and has not been “going out”, which will demand increased state transparency, and that in turn will demand structural reforms. The opening up for more foreign

workers is not only one such field, but also deregulation and tax reforms needs to be carried through (PMOJ, 2004-07-17). These reforms that could lead to increased FDI, reducing labor shortages and reduced price differences in relation to neighbor countries. The most important change in later years for Japan is the shift in focus away from its trade dependence on the US to a number of Asian countries. Positive is also Japan's current position with signs showing that the deflation period could be near over and an expansion of private demand, backed by banks that have largely come out of their crises and with employment in an upward trend.

Problematic for the long-term internationalization effort in a globalizing world is the restricted ability to use the English language among Japanese in general, especially among students. This is despite the fact that students generally have been learning English during 6 - 8 years, out of the 12 when reaching their high school exam. A skill that is on a level also below its main Asian competitors, with both Korean and Chinese students showing better scores than their Japanese counterparts when tested. Most alarming of all is probably that the self-confidence among all categories of Japanese students, good as well as bad, were the lowest of the three (Berlitz, 2004-04-13). Having partly understood the emergency in the situation the Ministry of Education has since late 2003 introduced a large-scale four-year "*Japanese with English Abilities*" project. Improvement of the quality of teachers is high on the agenda, but one of the long-term goals is also to make it possible for about 10 000 high school students per year to study abroad (MEXT, 2004-04-15). Nothing of the kind has been initiated or planned at the university level.

In the continued process of internationalization the Tokyo Stock Exchange has approved the first Chinese firm to make a public offering, the Xinhua Finance Ltd. The company is the financial arm of the state news agency in China and is providing financial information and credit ratings related to companies on the mainland (TSE, 2004-09-16). Products that are increasingly in demand by other Japanese companies seen in the light of the increasing importance of the Chinese market.

It is important for the future that South Korea, China and Japan have agreed to jointly develop the communication technologies needed for the fourth-generation (4G) cellular phones. An article that is an important trade item for the three parties and is expected to come into commercial use around 2010 (Nikkei Net, 2004-04-05)<sup>93</sup>. 4G cell phones are expected to become 50 times faster than 3G phones in transmitting information, with transfer rates equal to what is today found in fiber-optic communication; in the range of 100 megabits per second. This should make possible a crystal-clear TV image on the display even when,

traveling on a fast-moving train. The number of mobile phone users in the three nations in 2004 accounts for about 30% of the world's users, which could possibly make the protocol into a global standard. The three nations plan to hold regular working-level meetings to share information and encourage cooperation between business and research institutes. South Korea, China and Japan also plan to collaborate in adopting common communication technologies and to cooperate when the International Telecommunication Union (ITU) adopts an international frequency spectrum for fourth generation mobile phones in 2007 (ITU, 2004-05-10).

### **3.2. Trade**

The history of the Japanese trade relations with the rest of the world can be traced back to the forced opening to trade by the US in 1854. During the 50 years that followed, the Meiji Restoration in 1868, Japan adapted a selected number of foreign social and technological innovations to its own ends. Japan was one of the few nations in the region that avoided colonization, and its government wanted to preserve national sovereignty. Being both poor and densely populated the country had a natural comparative advantage in labor-intensive manufacturing like textile products. The relation to its trade partners was often complicated, and during these years' Japanese exports were often met discriminatory trade restrictions imposed by trade partners fearing imports. As for economic policy during these years Japan economic liberalism was never fully accepted as the dominant ideology. At the time of the worldwide economic slump, which followed the conclusion of World War I, also Japan began raising its tariffs significantly. In the wake of the 1923 Great Kanto Earthquake, Japan raised tariffs further, and by well over 100% on many luxury items. Instead of reducing tariffs back to their earlier levels after the immediate crisis was over, Japan continued to raise its tariffs throughout the 1920s. With the installation of the Inukai Tsuyoshi cabinet in 1931, Japan moved further away from economic liberalism. In the years that followed policies were mainly aimed at controlling inflation, as the economic system in the West entered a time of crises. When Japan launched the Pacific War, during WWII, it included the aim of creating a Greater East Asia Co-Prosperity Sphere. After the war, when the country had been defeated and was practically in ruins, it was first run under occupation by US military forces. The US occupation authorities put into place a new set of economic institutions and implemented a new economic direction that were largely modeled after what had come to be called the "*New Deal*"<sup>94</sup>.

In the build up of its economy and trade in a post WW II world, Japan benefited greatly from the experience introduced by the US that, but the country continued to apply a conservative approach in economic affairs. During this period, what probably was the only real opening to establish economic liberalism was missed, as this period was to be followed first by the war in Korea and then by the development of the Cold War. This led not only to the deteriorating relation with China, but also to the Soviet Union that continued to move from bad to worse. Still, it was the relatively open international economic order in the area of foreign trade that proved to be the opportunity that was needed to create the basis for much of the Japanese wealth.

Japan not only came to fully explore its comparative advantages in production, but it also saw the advantages given by the introduction of GATT and its successor, the WTO. Two organizations that have been devoted not only to facilitate trade, but also to reduce tariffs and barriers in international trade. Benefits obtained from trade have undoubtedly contributed considerably to the fast income growth and rising living standards in post WWII Japan. This process in the 1950s was further supported by not only the US, but also the World Bank and the IMF, that directly contributed to the Japanese economic development. Among many much-needed infrastructural projects receiving support at the time was the construction of the famous Shinkansen (bullet-train) railway.

In later years, continued positive contributions from its foreign trade have been important for the economic stability, in a time of a stagnating domestic economy. Japan's foreign trade for fiscal 2003 showed a positive trend with exports for the year increasing by 6% to 54 trillion (USD 480 bn), while imports grew at a slower rate, 4%, to 44 trillion (USD 363 bn), leaving a trade surplus of over 10 trillion (USD 118 bn). For the service trade, the deficit from 2002 of 3.7 trillion fell by over 60% to 1.5 trillion for 2003, which was much due to fear of SARS and international conflicts that reduced the desire to travel abroad (METI, 2004-05-17).

Meanwhile, Japan's export to the US continued its long and near constant decline, but still the Japanese trade surplus climbed by 7% to 604 bn (USD 5.5 bn) which was due to a sharper decline in imports than exports. The falling imports were the result of the ban on beef imports, caused by an outbreak of mad cow disease in the US. The continuous decline in exports is largely explained by the fact that Japanese automakers are assembling more products at their plants in the US as a result of the dollar's fall against the yen (MOF, 2004-03-25). However, Japan's most important export destination in 2003 was the United States valued at USD 115 bn, followed by China taking USD 57 bn worth of goods with Korea third, importing to a value of USD 35 bn (JETRO, 2004-02-17).

#### **Russia and North East Asia - in times of globalization**

During 2004, trade has continued to expand, reaching record high figures for both imports and exports over a six-month period. Total trade for the six months reached 51 trillion, with 29 trillion in exports and 22 trillion in imports, leaving a surplus of over 7 trillion, up 17% over the same period in 2003 (METI, 2004-11-10). Exceptional figures in a year when in Yen terms export prices increased by 1.8% during the year while import prices increased by 7.4% (BOJ, 2005-01-14). The boom could be over as export figures showed signs of flattening out during the latter part of the year, but with expectations of renewed growth by the second half of 2005. Of the export products for the period, the three dominating and nearly equally important groups were electrical equipment, transport equipment and machinery. Each has contributed 7 – 6.1 trillion, respectively. As for destinations, the US is well ahead of China, 6.6 as to 3.8 trillions, but with the former decreasing by 0.3% and the latter increasing by 24%. At the rate of increase shown over the last year, China (excluding Hong Kong) could surpass the US as Japan's most important trade partner already in 2005, and for sure in 2006, and also as export destination by 2007<sup>95</sup>.

Despite the surge in oil prices, ASEAN remains the biggest source for imports ahead of the US, the Middle East and the EU. The four being very balanced with a difference of just over 10% from the level of the ASEAN at 3.4 trillion to the EU at 3.1 trillion. Exports to Korea and Russia stood at 2.4 trillion and 0.2 trillion respectively, with imports from the two at 1.2 trillion and 0.3 trillion, respectively.

Generally speaking and among its neighbor nations, Japan's spending in China the money it earns in Korea. Still Japan is improving its trade balance, from having had a USD 20 bn deficit vis-à-vis the other two, this has in only three years contracted to USD 1 bn deficit. This improvement can be traced back to the fact that Japanese companies have invested more in own factories in China, in difference from Korean companies that continue to trade with their mother company. Still Chinese and Hong Kong exports to Japan grew by 22% in 2004 to USD 80 bn, lifting the Chinese share of Japanese imports over 20%, while Korean goods constituted 4.7 %. Over the years since 1993 the share for China in the Japanese import has grown from 8.5% to 20% in 2004 while imports from Korea instead slipped 0.1%, to 4.7 %. The gap between the two exporters has widened sharply, especially over the last few years, as the difference was only 9% as recently as in 2000, having widened to near 14% by 2004.

The positive Japanese trend in relation to China has continued, despite the fact that the trade balance has for long been favorable for Beijing. The ever more tightly knit relation between the nations is also shown by the fact that Japan has emerged as China's most important trade partner with China surpassing the US

in importance for Japan. Mutual trade with China, including Hong Kong, in 2004 came to a value of USD 213 bn (export at 86, import 127), US trade stood at USD 205 bn (137, 68) and trade with the EU at USD 152 bn (95, 62) (MOF, 2005-01-25). This can probably be seen as a result of the Japanese investments in China that have remained strong since many years. Japan has constantly been behind in the relation, but in February 2004 Japan posted a monthly surplus in its trade with China for the first time since March 1994. During the month, Japan's exports reached 590 billion and imports 576 billion, leaving a surplus of 14 billion, showing the largest monthly increase in exports to China ever; +57% (METI, 2004-03-25). When the year was summed up it proved to be the only month with a surplus with China during the year. In the trade relation with the US and the EU every single month during the year generated a surplus of at least USD 2 bn (web-japan, 2005-01-31). Still China's export to Japan includes a high degree of labor-intensive products, typical for a newly industrialized country. Although the export is being based on cheap agricultural products, clothes, and traditional computers, has still meant yearly deficits for Japan in the range of USD 20 – 33 bn during the years from 1996, with the record deficit dating back to 2001 (web-japan, 2005-01-31). Although China has increased the share of machinery and high-tech products in its export, it still has its base in lower-end products. There has been some attempts in Japan to restrict imports of Chinese agricultural products, with the arguments for such restrictions being based on what is an over usage of chemicals in China's farming sector.

July 2004 came out as a special month in the foreign trade history of Japan since the beginning of the current statistical series in 1947. Trade with Asia was the highest ever at 2.6 trillion, imports reached its second highest ever at 1.9 trillion yen, resulting in the third highest surplus ever at 750 billion. Trade with the rest of the world also reached the second highest ever, with 5.3 trillion in exports and 4.2 trillion in imports, leaving a surplus of 1.14 trillion. Of the export products, semiconductor-manufacturing equipment was leading with a 32% increase followed by steel that was up by 23%. On the import side, oil products were up by 53%, coal by 52% and crude oil by 23%. Trade surpluses for the month increased also for the most important market, the US and the third market, the EU, by 13% and 29%, respectively (JT, BOJ and MOT, various dates). Japan showed a worldwide trade surplus for 2004 of USD 120 bn, which was up by 18% over 2003 (MOF, 2005-01-25).

### **3.2.1. WTO and (free) trade agreements**

After the US occupation ended in 1952, Japan applied to join the GATT. The application was initially opposed by a number of countries, but with strong US



support, Japan was granted provisional membership in 1953 and full membership in 1955. Once a member of the GATT, Japan became a member that relatively passively participated in the rounds of multilateral negotiations under GATT, including during the Tokyo Round of negotiations of the 1970s.

Due to poor settlement procedures under GATT, many trade conflicts that involved Japan still emerged during the 1960 and 1970 and had to be resolved bilaterally, often in a, for Japan, discriminatory fashion. In addition to GATT's consistent forms of protection, such as antidumping measures, Japanese exports were also subject to innovative "*gray-zone*" measures. The trade relation between Japan and the US gave rise to a number of new expressions in the trade arena, later to be used in other bilateral trade relations over the world. First came the "*orderly market arrangement*" (OMAs) that was invented by Japan and the US in the 1950s and applied to textile trade. This was to be followed by the so-called "*voluntary export restraints*" (VERs), which the US and EU applied to Japanese steel and automobile exports in the 1980s<sup>96</sup>. In the 1990s, Japan and the US invented the use of "*voluntary import expansions*" (VIEs). The first of these two had the aim of restricting the penetration of Japanese products on the US market, while the VIEs supported the sale of US products in Japan.

With the establishment of the WTO in 1995 that included an improved dispute settlement mechanism, the settlement of international trade conflicts from the Japanese side took a new turn. This strengthened the possibility for fair settlement, and the ability to oppose discriminatory trade protection by partners. This was demonstrated in 1995 when Japan refused to agree to US market-opening demands, and threatened to open a case by the WTO. This case came to be settled out of court by the US. Since then, Japan has brought about one case per year to the WTO, with about half the cases involving the US and about half of these involve the automobile industry<sup>97</sup>.

While Japan, China and South Korea have followed the nondiscriminatory principles of the WTO, all have begun to feel threatened in international negotiations by the fact that among the world's 100 largest economies, practically only Japan, Korea, China, Taiwan and Hong Kong are not a part of any regional cooperation framework. It is in the light of this situation that the eagerness in the region to conclude FTAs should be understood. A tendency that will appear repeatedly in the following chapters. Before any such negotiation process can start, both the process itself, as well as the results, are being analyzed to assess the possible impacts on competing industries in the participating countries. Tee analysis should preferably indicate a positive outcome of an agreement for both parties.

### **FTAs - Free Trade Agreements**

The moment that really set-off the idea among all major trading nations to try to sign bilateral trade agreements was the collapse of trade negotiations at the WTO summit in Cancun, Mexico, in 2003. At such negotiations Japan is looked upon as one of the “*Group of 10*” WTO members that have remained the most protective of the large food-importers that clearly contributed to the breakdown. Although numerous FTAs had already been signed in the world at the time, they had mostly been focusing on neighboring countries, as in the case of NAFTA. It was the US that started the trend in signing agreements with individual countries far away when no international agreement could be reached under the WTO in Cancun. In the case of Japan its first FTA had already been signed with Singapore in January 2002. Which was an agreement that could be concluded without having to touch upon the thorny issue of agricultural products in the negotiations. Japan’s second FTA, with Mexico, had been negotiated with the intention to be signed already during the visit of the Mexican President Vicente Fox to Tokyo in October 2003. That proved impossible and it instead took some 20 months of, sometimes bitter, negotiations to reach an agreement with Mexico. The main reason for the prolonged negotiations was the continued Japanese resistance in opening up its trade in agricultural products. The signing stage of an agreement was finally reached by the end of March 2004. Mexico is a country of symbolic importance in relation to Japan, as Mexico was the first country that, already in 1888, allowed Japan to sign a treaty of amity and trade. At the time, this was Japan’s first ever reciprocal and equal treatment pact with a foreign country (Secretaria de Economia, 2004-03-11).

In an attempt to prepare for the future, the government has outlined a basic plan to promote free-trade agreements, with Asian partners to be given priority. This could be seen as a beginning of a long-term attempt to help build an East Asian trade community, based on the ASEAN+3 process, and with Australia, New Zealand and India that Japan would like to include in such a process (PMOJ, 2004-12-21). The plan includes a set of 12 criteria that will be used to choose potential FTA partners. The establishment of FTAs would help strengthen Japan’s economic power and solve political and diplomatic issues. The latest countries included on the list of possible FTA partners, with negotiations to be initiated during 2005, are Chile and India with preliminary agreements planned and prepared for signing in 2005 and 2006, respectively. The economic benefits to Japan of most kinds of FTAs in the region are probably less economic than psychological. What could be seen as more important from a Japanese perspective would be the political weight that such a regional trade arrangement would give in the Asian region, but also to the region as a whole.

In discussions in economic circles the possibility of a future tri-lateral FTA that would then include Japan – China – Korea is often mentioned. Korean sources have estimated the outcome of such a tri-lateral FTA and have set the advantage of such an arrangement to be the greatest for Japan. The benefits to be shared for the group would come to near USD 120 bn, out of which Japan could count on approximately 60%, China 40% and Korea 10%, or near USD 72 bn in favor of Japan. In GDP terms, such an FTA would bring near 6% to China, about 1.7% to Korea, but only 0.6% to Japan (KITE, 2004-09-13). An FTA among the three would bring not only economic benefits, but also political ones as a counterweight big enough to the EU and NAFTA. Korea, China and Japan would be a strong combination, especially in the global manufacturing industry to gain international status that matches their combined economic strength. The pressure in Japan to take serious steps in this direction is also mounting from business circles and top business leaders organizations with the same kind of process taking place also in China and Korea. The most influential lobby group in Japan, The Japan Business Federation, is strongly in favor of further swift steps on the road towards increased free trade, to promote mutual trade and integration (Nippon Keidaren, 2004-10-21). The purpose is to promote the conclusion of free-trade agreements as soon as possible, as Japan needs economic pacts with other Asian nations, including FTAs, to secure its future prosperity. Although the process is full of stumbling blocks Japan has become increasingly eager to conclude FTAs, and especially so if a future FTAs could be negotiated that includes Korea, or preferably, even China.

### **China**

Discussions on a future FTA between Japan and China are ongoing although it has not reached a stage of official contacts on the matter. However, it could be expected to take place in a few years time, and if nothing exceptional will change the agenda, then could be expected to be about to be implemented inside 10 to 15 years. To make China a reliable negotiation partner, it should first convince the world that it can comply with the regulations it accepted in the WTO agreement, where compliance is still to be applied with nearly 100 items in the WTO agreement (JT, 2004-11-13).

Small, and medium sized, industries in Japan are not only finding exports of high-grade products to China an ever-larger growth sector, but also more basic products find a market in China. Examples of such are synthetic fibers produced in Japan that are used to make European designer label clothing in China, fish and crab from Japanese vessels are brought in to China, but also products like cedar and cypress for housing interiors have seen increased export. Japan's export to China and Hong Kong reached close to 10 trillion during 2003, and is approaching the United States as the most important Japanese export destination.

### **Russia and North East Asia - in times of globalization**

## **Korea**

This passage could serve as yet another example of how difficult it is not only to organize a possible FTA, but also that relations among countries can change for the better. It is not many years ago since a discussion about a possible FTA between Japan and Korea would not even be a matter to discuss. Only a few years ago, a Japan-South Korea FTA would have proved to be too problematic, if not impossible, politically. Generally South Korea has higher protection levels for its domestic market than Japan, 7.9% and 2.9%, respectively, and has also pursued a policy of actively discouraging imports from Japan. An "*import diversification program*" that had to be adapted in June 1999, as a part of the IMF conditions for a standby support package granted in late 1997, during the Asian crises. When import restrictions were abolished in 1999, imports from Japan surged in a number of products groups. A future FTA is likely to further increase Korea's trade deficit with Japan. However, Korea is expected to enjoy a surplus in services and its overall trade balance would improve. To make sure that the Korean deficit will decrease in the long run, an FTA must open-up for dynamic effects and facilitate for investments. The promotion of Japanese investments in Korea could somewhat offset negative trade effects at the same time as enhanced productivity could help lift the Korean GDP. The process of establishing an FTA with Japan is, of course, of interest to many of the neighboring countries in Asia. However, negotiations started with its first meeting of delegations in Seoul in December 2003, and have since taken place approximately every two months (JT, 2004-05-12).

Although Japan and Korea are major players in world trade, the effect of a FTA will have an almost negligible effect on world trade and the benefits are there for Korea and Japan to share. Steps in the right direction are the taxation treaty with Korea that came into effect in late 1999, and the negotiations for investment and mutual recognition agreements that started already before the FTA came on the table. In order to maximize the benefits of a possible FTA, various bilateral cooperation agreements needs to be expanded. For example, the Japan-Korea Industrial Technology Cooperation Foundation and Korea-Japan Industry Cooperation Foundation have been achieving results steadfastly in terms of fostering industrial technology among small businesses, developing human resources, and enhancing productivity. Cooperation is particularly needed in the areas where both Japan and Korea are internationally competitive. In such sectors, the two severely compete with each other, but this is also fields where inefficient over capacities exist. An FTA would also be beneficial in sectors where intra industry trade is underdeveloped. To realize such cooperation, one suggested way could be the establishment of a Korea-Japan Industrial and Technological Cooperation Council, comprised of private businesses. The positive effects from increased bilateral trade will be seen through the abolition

of tariff and non-tariff measures, leading to falling prices in the two markets (KIEP, 2004-10-10). Regarding the ongoing FTA talks between the two countries, the Japanese Minister of Finance, Tanigaki, has warned against premature expectations, indicating that rather than immediate results, both nations should look for long-term benefits (CI, 2004-05-20).

### **The US**

As briefly mentioned above the latest official complaints that has been brought up against the US in cooperation with a wide range of nations, among them Korea and the EU was against the US “Byrd Act”. This Act approves transfers of incomes from anti-dumping fees levied in the US, and paid by the foreign exporters, on to the industries mostly affected by the under-priced import. In this way the foreign exporter gets punished twice, first by the dumping duty and the by the fact that local producers get unsanctioned economic support. That was also the view of the arbitrators at the WTO when the result of their investigation was presented which gave Japan the right to retaliate to a value of USD 80 million per year (WTO, 2004-11-25). From this date on the group of countries that have filed the complaint can retaliate in the form of import duties on US products, of up to 72% of the amount being transferred to US firms under the Byrd Act. That is up until the date when this issue has officially been settled among the parties involved. To retaliate against what is Japan’s most important trade partner, so also for many of the other countries that complained, is a highly sensitive matter. How the possibility to do so will be used, is likely to vary widely among the countries that won the appeal.

Any action that will be taken to retaliate will diminish the Japanese hopes of possibly start a round of near future FTA negotiations with the US. Something that the US Trade Representative has set out as impossible as long as Japan keeps its agricultural market practically closed for US products. Over the years, this has especially referred to rice, but also to beef imports, due to outbreaks for mad cow disease in the US (USTR, 2004-09-21).

### **Asia**

Japan has agreed to start serious FTA negotiations with the ASEAN group of ten countries in April 2005. The mutual aim is to reach a full free trade status with six of the more advanced economies in the group by 2012. Negotiations with the full group has practically not advanced at all, as Japan is already, since 2004, in discussion bilaterally for an FTA with Malaysia and Thailand, having already concluded one with Singapore and has signed an outline with the Philippines. Talks with the ASEAN group will focus on more or less the same difficult questions again as with Mexico. Tokyo demands lower duties on auto parts and electronics, while Thailand wants access to the Japanese labor and agricultural markets, while the most disputed question with the Philippines was Japanese

steel export (JT, 2004-11-21). In the case of Malaysia, negotiations were started in late 2003 and the major stumbling blocks here are the Japanese export of auto-parts and Malaysian exports of commodities like plywood, but with rice being excluded from the negotiations (Kyodo, 2004-11-04). Of agricultural products, rice remains in the centre of attention, with Thai requests for non-tariff access in its negotiations with Japan, something that was rejected by Prime Minister Koizumi by saying: *“What is impossible is impossible, even if a lot of time is spent on it”* (JT, 2004-10-13).

### **The FTA with Mexico**

As mentioned above Singapore became the first country to conclude a FTA with Japan, while the second with Mexico had to cover practically all kinds of products, and especially agriculture. At the same time Mexico holds an important position as a member of NAFTA, along with the US and Canada, and as a place where Japanese industry can enter the North American market. This is further enhanced by ideas on future negotiations on that side of the Pacific for a Free Trade Area of the Americas (FTAA). A future FTAA that could come to include countries in both North and South America, extending the possible market to a total population of 800 million generating a GDP of USD 10 trillion.

With its second FTA in hand signed with Mexico in September 2004, expected to take effect in May 2005, Japan gained much experience in the field of organizing such a complex negotiation process. Looked upon superficially, Japan has the technology while Mexico has the agricultural power and low cost labor, which makes the two economies seem perfectly complementary. Ironically, it has been these sectors that made negotiations last for almost two years, with the most interesting part of the deal with Mexico being the treatment of the sensitive agricultural products. To make the deal with Mexico possible, Japan had to make large concessions in the negotiations and no country before Mexico had been given such preferential tariff treatment.

The agreement with Mexico will give Japan more access for car and steelmakers and lower prices for imported farm products. Just the achievement to conclude an agreement indicates that groups, both in favor and against, have had to adjust their positions to make an agreement possible. For the Mexican side it has been estimated that the FTA will bring FDIs of USD 1.2 bn/year over the coming years. Over the ten years following the introduction of the agreement the 20 – 30% tariffs levied on motorcycles, photocopiers, games and computers from Japan, will have to be lifted along with the lifting of import quotas for a number of other articles. During 2003 Japan imported food products from Mexico to a value of around 3.8 trillion yen, which make up more than half of total imports from Mexico. There will now be an 80 000 tons of tariff-free quota of pork, and

an annual low tariff quota for 6 500 tons of orange juice, 4 000 tons of fresh oranges, 6 000 tons of beef and 8 500 tons of poultry (Secretaria de Economia, 2004-03-11). Quotas should be increased after a transitional period, but the tariffs will not be set until will into the transitional periods set for different articles. The delay indicates the fear that any sizable step might antagonize Japanese farm groups, which are already ahead of ongoing trade talks with other Asian nations. The symbolics in lowering trade barriers in the agri-sector are so strong, that any step taken becomes minimal. At the same time, tariffs on about 380 less sensitive Mexican agricultural products will be fully eliminated. The sensitivity to farmers' interests from the government's side is strong, and there is a long road ahead before Japan's agricultural market is opened.

The agreement that will go into effect in 2005 and will boost the Mexican exports to Japan which reached USD 1.8 billion in 2003. Japan is still a very small partner compared to the US, Mexico's largest trading partner, which accounted for 85% of Mexican exports and 75% of Mexican imports in 2002 (ibid.).

### **3.2.2. Neighbor relations**

Japan's influence on institutions in the global economic scene has always been, and still is, smaller than one would expect from a country being the world's second largest economy. Japan's possibility to influence issues are not only limited by the dominance of the US and its unwillingness to risk a rupture with them, but also by the historic legacy of suspicion and distrust from neighbours in Asia. The neighbor relations in the region are a sensitive matter, as over the last 100 years Japan has been at war with all the its neighbours in the region. Although relations have improved greatly over the last few years, the questions related to issues dating back to the wars of the 20<sup>th</sup> century are constantly appearing among the news and are definitely complicating the relations among neighbours.

To a certain degree, it is a part of the national heritage for countries and nationalities to bear with them a certain pride about their own history. As part of the nation-building process, we are already being taught from basic school, and indirectly by what our parents were being taught, our nation's reason for being. However, the description of historic events must give a fair account on views as well as deeds during the described eras. In a world of just some decades back, a slightly lower level of authenticity, or more nationalistic to put it that way, could perhaps be seen as sustainable. At the time it could be argued that it was unlikely that the pupils at the receiving end of the education, as for the adults, were ever to interact with the foreign nations described. Currently, with an

unprecedented increase in contacts through business and tourism, to simply exclude the sufferings caused to innocent civilians during wars, is simply a behavior that belongs to past centuries.

### **China**

In 1931, Japan initiated the occupation of northeastern China and managed to create something of a state in Manchuria. It was not until 1937, when Japan initiated a larger-scale military operation in China, that any real resistance from the central government, already under pressure from communist forces, mounted. The combined resistance from the two against Japan proved more successful, although Japan established several governments that were supposed to lead China, for example in Nanjing. The combined communist and Chiang Kai-shek forces joined the Allied Group of forces in its resistance, after the attack on Pearl Harbor in 1941, and China was again to decide on its own future after the Japanese capitulation in 1945.

The aggression from the Japanese side against China in 1937 - 1945 has been an issue for Chinese demands for apologies and compensation. Apologies have been made, but it has not sunk in well in China when, periodically, Japanese politicians have provoked and hurt many Chinese. Japan has not exactly followed the example of Germany in dealing with its historical war memories in relation to its neighbours, although the situation is not really comparable between Europe and Asia as there are no land borders between the parties here. A geographical feature is bound to have reduced the pressure, and necessity, to reach mutual acceptance and understanding between the two neighbours. The building of mutual respect and trust will need even more time for two important political powers, that for long has paid tribute to two fundamentally opposing political and economic systems, even more time will be needed.

It was not until the Inter-Korean declaration had been issued, in late 1972, that diplomatic relations between the two came to be re-established. Back and fourth neighbours have considered if to let bygones be bygones, but a strong suspicion and the relation with China has never really gone beyond history. One of the problems for leaders on both sides is that they would not like to be perceived by their home opinion as to soft on history. The present Japanese Prime Minister, since 2001, Koizumi apologized to China for sufferings caused by Japan during the wars in the 1930's and 1940's, in October 2001, and so had a number of previous prime ministers. Despite these attempts to satisfy the Chinese public, especially Internet based nationalism has been building up, but to measure its strength is very difficult. A large petition was circulated in China demanding compensation to wartime victims poisoned by e.g. chemical gas from dumped Japanese bombs and other leftovers from WWII. A number of court cases against



Japanese companies and the state for economic compensation have seen mixed success. Parallel there has been sentiment in Japan that it has been enough with excuses for past times and that it must be time to move on. The single act that has complicated co-operation in the region the most in later years is probably the Japanese Prime Minister Junichiro Koizumi's continued visits to the Yasukuni Shrine that also honors 14 Class A war criminals<sup>98</sup>. The official excuse has been that the visits have been of a private nature, an excuse that has found little acceptance among neighboring countries. The visits to the shrine by the Prime minister has by a court ruling in Fukuoka, in April of 2004, been condemned as being unconstitutional, due to the fact that a visit to a shrine is religious to its nature and religious acts by the state body are forbidden<sup>99</sup>. On August 22 2004, which would have been a likely next date for a visit, the Prime Minister did not visit the Shrine. Instead, the shrine was visited by four ministers of the Cabinet along with 58 members of the Diet. The importance of this question was shown in the informal meeting between Koizumi and the Chinese President Hu Jintao in Santiago in November 2004; this was the first issue brought up by that the Chinese leader (JT, 2004-11-23). No commitment was given at the meeting, as there proved to be only just over a month, on New Years Day 2005, until the Prime Minister were to visit the shrine next time. The shrine remains a thorn in the side of all neighbours, but between the two big there is also another larger dimension. Between the two nations there is something like mistrust and vigilance as they are indirectly competing for the regional leadership, of both today and for the near future. Much of this mistrust from the Japanese side could be derived from the fact that China has become economically open, but has not yet opened up politically.

Any fear on the part of Japan about China being able to rival its supremacy economically, which is sometimes voiced, is simply not realistic in the near future. The current Chinese growth level of near 10% must probably come down by some percents inside a few years time to be sustainable. At the same time the Japanese economy has shown growth figures of its own, which pushes any Chinese catch-up further into the future. Japan is already having a per capita income over 25 times larger than China, a closing of such a gap, under normal circumstances, is just practically impossible in the foreseeable future.

Japan together with its western neighbor China are Asia's two most powerful nations, being relatively close in the cultural field and irrevocably so in geographic terms. During the last two decades they have also come to grow increasingly closer in economic terms. China, being a developing economy is in need of Japanese investments and technology, at the same time as Japan has increasingly come to source its low-cost articles of everyday use in China. That the overseas market in this case has proved an opportunity for Japanese

companies is probably without doubt, and that the Japanese market would not have absorbed as much of the Chinese exports without the large investments, is probably as true.

Over the past 15 years of relative stagnation in the Japanese economy, companies that were early movers into the Chinese economy have generally done well on that market. These overseas units of Japanese companies are also expanding their sales more rapidly than the parent companies, 16% compared to just 3%, in ministerial survey for Q2 2004 (METI, 2004-09-30). Of 160 major Japanese firms surveyed 65% were largely positive to the Chinese economic growth and stated that it has had a favorable effect on the Japanese economy (Kyodo News, 2004-05-12). Out of these companies, 68% had business based in China, 62% were doing business with the mainland with 36% having made investments (multiple-answers possible). Only 6% showed concerns about the possible moving out of production or any reduction of jobs in Japan. The rise of China, that was generally viewed as negative just a few years back, seems to have been forgotten. Only ten companies (6%) declared no involvement at all with the Chinese market.

International contention, including the nuclear standoff on the Korean Peninsula, environmental concerns and the global combat of terrorism are questions that have generally contributed to a strengthening of ties between the two neighbours. History has hopefully learnt that co-operation benefits both countries while isolation, or mutual agonizing will severely hurt both. At least theoretically, the two could part again and to say who would loose out the most from that kind of divorce is more or less impossible. Both would in such a case have to find new markets for its products as well as sources for inputs. A positively reciprocal and friendly relationship, that must not mean that the two always can agree on every single issue and can overcome every aspect of a troublesome past, will greatly benefit both countries in the long term.

What could be seen as worryingly for both Japan and Korea, as well as for many other developed countries, is the rapid rise in technological level of the Chinese manufacturing output and export. According to a Japanese survey it is expected that the technological level of Chinese products could soon make these products into a strong competitors. The value for 2004, set by 440 Japanese companies rating the technological level of Chinese products, came to 2.6 on a scale of 5, with Korean at 3.3 and Japanese at 4.0. Taking a ten-year perspective these values are set to shift strongly in favor of China, as the 2014 values set China at 3.8 and Japan at 4.1. Of the outsiders, the US is expected to have come down from 4.6 to 4.5 and Europe to remain at a constant 4.0 rating (Nihon Keizai, 2004-07-29).

Since 2001 Japan has started to scale down on economic aid and low cost loans to China, which has been far from appreciated in Beijing, where the loans have been seen as a symbol of friendship towards mainland China. Beijing had wanted to see the level of aid maintained, as many of the cross border investments between the two countries have benefited from these loans. However the level fell below 100 bn (USD 900 million) for fiscal 2004, for the first time since 1989, with the intention to phase out these loans completely during 2005 (MOFA, 2005-01-31).

What has become known as the “*Fusosha textbook crises*” is another of the issues that has contributed to negative goodwill for Japan among its neighbours. This history book for junior high schools, due to be introduced for the 2005 school year, has for the past several years caused friction as it fails to mention the e.g. Korean “*comfort woman*” and includes a controversial and forgiving descriptions of the events surrounding the “*Nanjing Massacre*”<sup>100</sup>. Already a version published in 2001, sparked criticism, but was adopted by only 0.04% of schools and criticism therefore faded. The new edition of the book is seen as worse because it does not include the few acknowledgements that existed for the criticized incidents in the 2001 version. Also Japanese civic groups have come to protest to the Japanese educational commission that is to approve the book (KT, 2004-09-01). To further put wood on the fire Japan granted a tourist visa for a private visit, to the former Taiwanese president Lee Teng-hui to spend a week in Japan in December 2004. Also Japan has declared its support to the One-China Policy, but from a Chinese point of view this was a break of the promise to bar official contact with the island and a sign of support for Taiwanese separatism<sup>101</sup>.

Also the Japanese side has had reasons to complain about Chinese behavior. The latest incident, with a violent outbreak of “*anti-Japanism*”, occurred at the final of the 2004 Asian Championships in football in Beijing. After China had lost the final to Japan, that included some doubtful decision making by the match officials, Chinese supporters rioted, Japanese visitors and diplomatic cars were attacked and supporters were filmed burning Japanese flags. Giving the incident a clear dimension beyond football. After this incident the Japanese side has also voiced its discontent over Chinese oil exploration in the Japanese Sea, leading to that also Japan has given away concessions for oil and gas exploration on what is considered to be Japanese territory. The conflict was aggravated further by the identification of a Chinese nuclear submarine clearly inside Japanese territorial waters in early December 2004. In early 2005 Chinese protests have mounted into several anti-Japanese mass demonstrations, which ultimately led to an official excuse from Prime Minister Koizumi for historic brutalities from the Japanese side.

As geography do counts, the two most important of the Asian economies have over the last few years surprisingly rapidly come to increase in importance to each other. Early Japanese investments in the Chinese market, and its support in extending production facilities in China, have enforced the economic contacts, creating considerable markets for each other's export. Still, and despite the fact that a number of arguments can be brought forward pointing to uncertainties in the relationship, aggravated by still unsettled issues of the past and protests in recent times, too much is at stake for both sides not to move forward. China's fast economic development has undoubtedly helped the Japanese economy to recover and China will continue to be a huge market, while Japanese investments and support has been crucial in the development.

### **Russia**

Since WW II it has been the small Kuril Islands that, more or less constantly, that has been complicating the agenda between Japan and Russia. Geographically, the two neighbours had, in 1875, signed an agreement that placed the Kuril Islands under Japanese jurisdiction and the island of Sakhalin under Russia. However, from the time of Japan's modernization that coincided with that of Russia, and that for both were initiated from abroad, the tension between the two also started to build up. With increasing Russian interest in its Far East, as demonstrated by the building of the Trans-Siberian railway, in the direction of a weak Japan, tensions were soon to mount again. Leading to the 1904 – 1905 war when Japan took over the southern part of Sakhalin, which was to remain under Japan until the end of WWII. Just in the closing stages of WWII, the current Kuril Islands dispute emerged. It involves two larger islands, two smaller and a number of very small islets northeast off Japan's northern island of Hokkaido. The Kurils were seized by military force by Soviet troops just days before the capitulation was signed with the US, on August 15, 1945. The occupation of the islands took place in the days in-between the first atomic bomb was dropped on Hiroshima and the Japanese capitulation. The unsolved conflict over the island has to this day prevented the two countries from signing a peace treaty after WWII. In 1956, the Soviet Union and Japan signed a joint declaration that two of the islands, Habomais and Shikotan, should be returned as soon as a peace agreement had been signed, while another joint declaration signed in 1993 confirms that the conflict involves four larger islands. The 1956 agreement has been brought back on the agenda from the Russian side as a suitable way of solving the conflict, while the Japanese side wants the negotiations to include four islands.

Despite this long line of conflicts, Japanese relations to Russia have continuously been improving during later decades, and especially so since the break up of the Soviet Union. Meetings between top-level leaders have been frequent while the

volume of both trade and FDIs are increasing, although riding on a bumpy road. In the background remains the dispute over the Kuril Islands that leave its mark on the relation. After the Russian peace agreement was signed with China in 2004, hopes increased that a breakthrough on the Kuril Island issue could be reached. Instead, it has been admitted by the Japanese foreign minister that “*clear differences exist*” (JT, 2005-01-15). As a result, a visit to Japan by President Putin, initially expected to take place during early 2005, has been postponed until a better understanding has been reached.

Trade between the two has never been very large and stood at its peak during the 1980s. It then fell off to a new low in 1991 and again in 1999, but in the last two years, interest has started to pick up and trade is again increasing (Jetro, 2004-11-29). When the first investment opportunities appeared in Russia after the 1991 break-up, and especially in the Far East, Japanese companies were quick to move in. The number of Japanese companies investing reached its peak in the region in 1991 – 1992. With the problems that faced them, probably having exceeded both their expectations as well as fears, the numbers have since fallen sharply to just less than a handful of companies entering the market in 2000, with a slow increase having been registered since (MOFJ, 2004-05-02).

A long-standing issue related to the rumored existence of a gold deposit in Japan, which should have been brought over by royalists during the years of 1916 – 1920 has at least been settled. It has finally been proved that the gold were either used to buy weapons to the white army during the war, used by its owners or have been handed back (Polit.ru, 2004-04-30).

### **Korea**

In the case of Korea, that is the once unified larger Korea, the then king Sunjong had to give up his position to the Japanese occupation in August of 1910. From then on Korea served as the Japanese Government of Chosen. Resistance and uprisings opposing the 35 years of occupation occurred, along with the forming of an exile government in China. The development during this period came to focus more on the economic support of Japan than the best of the local population. At the time of the Japanese capitulation on August 15 1945, Soviet troops advanced into Korea from the north until the 38<sup>th</sup> parallel, while US forces reached the line from the south. Forming a divide that has remained in place ever since.

At the same time as the two parties concluded an agreement to normalize diplomatic ties, in 1965, the right of Koreans to make historic claims against Japan were also terminated. Based on the treaty, that included a Japanese one-time compensation payment of USD 500 million in economic assistance, no

Korean individuals can raise claims for sufferings occurred before the end of WWII. Although the legality of the agreement has been questioned since, it has been continuously referred to by the Japanese side during disputes.

The former Korean President Kim Dae-jung took big strides in improving bilateral relations with Japan through his low profile and avoidance of historical issues. He proposed that the problems of the 20th Century should be resolved within the century. He also wanted to abolish restrictions on cultural exchange with Japan, although this could be seen as concessions to Japan. Much as a result of this the relation between the two has developed more into that of partners. As its concrete result, the two has seen booming trade and tourism, but also an increased numbers of ministry meetings. Most important, Japan and Korea agreed on an "*Action Plan for the New Korea-Japan Partnership for the 21st Century*", laying the foundation to jointly host the soccer World Cup in 2002. An agreement reached in two rounds of summit talks in Atami, in September 2000 between President Kim Dae-jung and Japanese Prime Minister Yoshiro Mori. Kim and Mori reviewed a number of bilateral issues, such as economic cooperation and respective North Korea policies. The "*South Korea-Japan Information Technology Cooperation Initiative*" includes an outline for the cooperation between the two countries in the information and technology sectors, aimed at invigorating the economies of the two countries. This joint study was also an initiative that has been further refined later to become the fundament upon which the discussion for possible future FTA between the two countries has been based.

To jointly organize the world's largest event, The FIFA World Cup in football, became an overwhelming success, but also a significant and important step in normalizing the relation between the two neighbours. Not only that, the arrangement became a tremendous success in sporting as well as goodwill terms for both countries. Over the last few years the nuclear and missile threat from North has been a factor that has further favored the improvement of good Japanese – Korean relations. Contacts between Japan and Korea are constantly improving, with over 10 000 currently commuting between the two daily. Additionally, a number of smashing successes stories on the cultural front, in TV broadcasting and pop, have come to fuel contacts further in later years.

### **North Korean**

Apart from the general threat post by the North Korean nuclear program the abduction of Japanese citizens by North Korea, and their return, has been the most pressing issue on the agenda. The Koizumi one day trip to North Korea in May 2004, bringing home five abductees and promising energy to replace nuclear needs, moved the initiative in the negotiations somewhat from China in

the direction of Japan, for a short while. At the same time as the six party talk negotiations has become stalled, also the Japanese initiative has failed to produce more than just a single success and the momentum have faded. In all another ten abductees are still said to be unaccounted for from the Japanese side, of which the North have stated that eight are dead and the last two have never been abducted. A considerable complication to the relation has been that the ashes sent to Japan, said to originate from one of the dead, through DNA testing, proved to have no relation to the family. A fact that was met with outrage in Japan, and the domestic pressure was strong on premier Koizumi to introduce sanctions on the North in response. At the same time the bigger issue, related to the future of six party talks, could be at risk of a complete collapse if sanctions are introduced (Kyodo, 2004-12-20).

### **Asia**

Japan is the US most important ally in NEA and it has been of US interest to improve relations between Japan and Korea. Especially important when seen to the background of the raising strength and influence of China in the Asian region. During the two terms of Clinton as president, the position and importance of Japan was not as clearly defined, as it had become since the takeover by President Bush.

Although Russia used to be a security concern near the top of the Japanese agenda, and still today remains a country with whom there is no peace agreement, the two now have a working relation. Despite this, Russia is probably the country in the region that is of least interest to Japan in the near future. As for all neighbours in the region issues related to the development of the nuclear issue in North Korea is of immediate interest also to Japan. Over a little longer perspective the possible peaceful re-unification of the two Koreas would also affect the situation for Japan and widen a market where Japan is already strong. In relation to China there is also a possibility of a re-unification between mainland China and Taiwan, peacefully or by force. If by force, and any other way in the near future is difficult to foresee, is bound to destabilize relations considerably in the region, and be very negative indeed on the relation with Japan. Also without a unification with Taiwan, the rapid rise of China as an economic and military power remains a long-term concern for Japan. To enhance its position as an economic power has shown to be both surprisingly simple and quick by the example of China. Its manufacturing and trade success has been followed up by large spendings on increasing the technical capabilities of a military power that already, in numbers, had an overwhelming strength.

### **3.3. Energy**

The years of strong industrial growth in Japan, from the 1950' until the first energy crises in 1973, was build on an ever increasing import of oil that had shown an unbroken increase in imports during that period. From the first major crises, energy demand recovered, and had passed the 1973 level by the time of the second crises in 1979 – 80. Again a minor fall in consumption was registered, followed by a more or less uninterrupted growth since.

During the last forty years, there have been some major shifts in the pattern of energy consumption that deserves to be mentioned. It was not until first years of the 1960 that the consumption surpassed 100 mtoe for the first time, with industry consuming over 80%. At the time of the first crises, consumption had reached 280 mtoe with the share for the industrial sector had fallen to 65%. In 1974 the transport sector consumed 15% while the commercial/residential sector used up 20%. After the first crises it took total consumption three years to recover to its pre crisis level and eight years after the second crises, but the energy use in industry has not surpassed its 1973 level as a share of consumption. It is instead entirely in the other two sectors where the increase in consumption has occurred, driving the energy need over 300 mtoe in 1986 and above 400 mtoe in 1997, with the shares for transportation and commercial/residential sectors standing at 25% and 30% respectively (ANRE, 2004-07-10). This is not a development that is unique for Japan, but instead looks practically the same in most developed countries, wherever more electrical appliances have come into use driving up consumption. On the transportation side it is a strong increase in car ownership and a shift from rail to less energy efficient road transport, of the ever-larger volumes, that has caused the shift. To make matters worse, any improvements in engine efficiency, over the last ten years, has by far been offset by an even more rapid increase in engine effect in cars and trucks. With increased efficiency and lowered consumption it has been estimated that total consumption should be 10 – 15% under the 2000 level by 2010. The available prognoses also suggest that by 2010 it should only be the housing sector that has increased its consumption compared to the 2003 level (NEDO, 2004-08-08).

When it comes to the mix of energy sources it used to be oil that vastly dominated, being the source of 77% of the energy used in 1973. As a result of the world energy crises that year it became apparent that the mix of energy had to be widened and large-scale imports of thermal coal for heating and electric generation commenced. Parallel the use of LNG also increased, after having come into its first large scale commercial use only ten years earlier.



IEA has set the Japanese self-sufficiency rate in energy to 4%, the lowest among the G7 countries, with most of the domestic energy coming from hydroelectric power. In an as volcanic country as Japan it could be surprising that geothermal power supplies only 0.1%. If the nuclear sector is included the level of self-sufficiency rises to near 20%, but also uranium is imported. Japan has been trying to diversify its energy base and had a dependency ratio on oil on 49% in fiscal 2001, but with 90% of the oil supply arriving from the politically unstable region in the Middle East. The other major energy sources are coal with near 20%, while nuclear and LNG each contributes with 13% (IEA, 2004-07-07). The government has actively promoted the use of new energy sources and has by law, from April 2003, required power suppliers to use a certain percentage of designated new energy sources (JT, 2004-05-15). From the atomic energy group prices in generation has been estimated to about JYN 6/kWh for nuclear, with coal and LNG generated electricity at about 10% above that with oil near at double the nuclear price and hydropower at yet 25% more (JAERI, 2004-07-12). Also in the long term planning, alternative and sustainable sources, such as wind power and geothermal heating, are expected to supply less than 2% of the energy consumption by 2010 (ANRE, 2004-07-10).

Breaking down projected primary energy supply in Japan in fiscal 2030, a ministry draft says petroleum will account for 42%, natural gas 18% and nuclear energy 15%. The ratio may change depending on the progress of energy-saving efforts or a possible slowdown in the country's economic growth (METI, 2004-05-18).

For the near future the greenhouse gas emissions in Japan are expected to exceed the targets set for 2005. The agency proposes the creation of a new system providing consumers with information about energy-saving methods as the Kyoto Protocol on global warming takes effect. Which it soon will after the Russian approval in January 2005. For the future that will follow under the regulations of the Kyoto protocol, Japan will probably have to buy its way out of a difficult future when it comes to emissions. As indicated in the above the use of fossil fuels will not be reduced enough to avoid a situation where Japan will be forced to buy carbon credits internationally, to find its way out of its dilemma.

### **3.3.1. Petroleum**

Although Japan has ten on shore and offshore oilfields in production, with the first coming into production already in 1976, it can only supply about 1% of national needs (Japex, 2004-08-07). Oil consumption has remained relatively

stable over the last 15 years, having gone up about 10% between 1988 and 2003. From a level of 240 mty in 1988 to about 260 mt in 2003, which contrasts the increase of roughly 50% in consumption during the same time period in China and Korea.

From the point of view of energy security both Japan and China have an interest in trying to widen the sourcing of its oil needs, away from the instable region of the Persian Gulf. A Persian Gulf dependence that in the case of Japan stood at 75% at the time of the first energy crises, during 1994 briefly passed under 70% and has during the years of the 21st century been stable around 81% (Stat office, 2004-08-02). Both countries have proposed to Russia the building of a pipeline from Siberian oil fields, which have emerged as two competing routes. A set of conflicting interests that is of long-term interest to all the three parties involved. To build a pipeline, in accordance with the Japanese proposal, is estimated to take investments in the range of USD 10 – 15 bn. The plans include a pipeline from near Angarsk, west of the Lake Baikal to the Pacific coast and the oil terminal in Nakhodka. From the Russian side it is not only assumed that the project in itself should receive large-scale economic support from the Japanese side, but would also further promote investments in other sectors of the Russian economy.

A decline of 7.7 % in crude oil imports in February to 18.3 mt, made it the fifth straight monthly decline. Imports from the Middle East accounted for 92.6 percent of the total, up 13% from a year earlier, with The United Arab Emirates as the largest oil supplier, with imports increasing by nearly 10% percent to nearly exactly 5 mt (ANRE, 2004-03-31). November import level of USD 42.5/bbl

State owned Japan Petroleum Exploration may join a research project to gauge recoverable oil reserves in Russia's Far East and could become the first Japanese company involved in such a mission in eastern Russia. Estimations have set the available volumes to as much as 14 billion tons. Apart from the high political risk, severe weather and geographical restraints adds additional risk dimensions to the already high business risk of investing in the area. To participate in securing supplies from sources abroad, through investments in fields and exploration, has been set up as a part of the state policy for the future, and this initiative would therefore be fully in line with the policy guidelines.

Japan has suggested to neighboring countries and the ASEAN group of countries to jointly build up an Asian emergency oil stockpile, but this proposal has been largely rejected. To build such a stock would require huge assets to building a large enough storage, especially in times of higher energy prices. This is also in a region where the growth of consumption is three times that of the

world average (ASEAN and ADB, 2004-06-16 – 08-17). However, there is a need to ensure reliable and affordable energy resources for the future in the Asian region, where still 20% of the population is living near or under the poverty level. How this is best achieved is still to be agreed on.

### **3.3.2. Gas**

The first energy plants using LNG were introduced already in 1963 and the first domestic findings of commercial gas was made in the late 1970's (Japex, 2004-07-17).

Although gas came to be imported to Japan in the form of LNG relatively early, it was not until after the first energy crises that any widespread investments in its use came about. The imported LNG's main use is for electric generation and has been expanding its use from about 1% of generation in 1970 to about 25% by 2003.

As Japan has limited findings of natural gas of its own, it alarmed Tokyo when China found natural gas near the median line of the East China Sea. Tension over a Chinese gas prospecting in the East China Sea has started to mount, as from a Chinese point of view, this is Chinese territory and Japanese requests for detailed information about the exploration are seen as not justifiable. The two countries have never demarcated any border in the disputed East China Sea, and Japan has announced a median line as border, but has only discussed this with China and there is no border treaty. A new 470 km pipeline will by May 2005 connect this new Chunxiao field to mainland China, allowing for the full exploration of the field. This is by the Japanese side seen as a possible intrusion of its ocean zone. Japan has, as a counter measure, also declared its intention to explore for hydrocarbons near the median line. In the 2005 budget, 23 bn has been set aside by the government for exploratory drilling and for a new marine resource prospecting ship to be used in this area (Kyodo, 2004-12-15). Both sides talk about negotiations, but so far, this has not materialized, although the presidential meeting in November concluded that the East China Sea should not become a "*sea of confrontation*" (Xinhua and JT, 2004-09-08 – 11-23).

### **3.3.3. Coal**

As in many other fields of minerals Japan has domestic findings of coal, but these have been relatively small and spread out, first of all on the island of Kyushu and Hokkaido. Domestic sources have played an important part in the

early development of Japan, as was the case also in Europe, and partly maintained this position up-until the 1960's. Faced with competition from new large-scale and open-pit mines, in first of all Australia and Brazil, the high extraction costs in the small domestic under-ground mines has nearly completely forced them out of business.

The use of coal in Japan was much an import of coking coal to the steel industry up-until the first oil crises. At the time the import of coal came from the US, but slowly came to arrive from a wider spectrum of countries. This widening from the time of the first crises was partly a result of national initiatives, initiated to secure future supplies in the near abroad, e.g. in Australia, Canada and in later years also increasing from Indonesia and Kina. With a relatively stable steel production, in the range of 100 mty, also the input of coking coal has also been kept relatively stable around 60 – 70 mty. During the same 25 years the import of thermal coal, on the other hand, has increased from a level of 12 mty around 1980 to surpass 100 mt for the first time in 2003 (Coaltrans, 2004-07-05).

Japan, with its only symbolic domestic mining, is the world's largest importer of coal with 173 mt imported during 2003. During later years it has been the problems with the nuclear plants that have maintained the consumption of coal at power plants and that made thermal imports pass 100 mt. Originally the METI had estimated that a 10% reduction in coal consumption would be needed to meet Japan's CO2 targets, but near capacity steel production in combination with an considerable increase in the use of thermal coal due to the nuclear problems has played havoc with the planning. A reduction that was originally meant to mean a 10% and 6-mt reduction by 2010 for coking coal would in the current situation mean a 27% and 20-mt reduction to reach the 53-mt target. For thermal coal to follow through on the METI estimations, it would also require a 30% reduction from the current level until 2010 (METI, 2004-05-10).

Of the generation the effect generated from thermal coal reached 7% in 1990, and despite having doubled its capacity to 25 GW by 2000 the share in the generating had reached only 11%. Still the extension of a number of thermal coal power plants in Japan is expected to add another 7 GW of capacity inside the coming five years (Coaltrans, 2004-08-02). With prices following the rising oil prices settlements for coal has surged, from about USD 40/ton to USD 80/ton and expected to go well above USD 100/ton for coking coal during 2005, while thermal coal has increased from USD 25 – 30/ton to around USD 45/ton (ibid., & JISF, 2005-01-19). This is partly a new situation as a buyer cartel organized by the Japanese electric companies has for many years been practically setting world prices for the year to come in negotiation with the major suppliers. The outcome has then been a used by others all over the world as a benchmark in

negotiations. This co-ordination has fallen apart in later years as the number of both exporters and buyers on the market has increased considerably.

Still the sourcing of energy is an arbitrage between security of supplies and having the possibility to profit also from market changes. Coal is to play an important part also in the future, being much cheaper than LNG, and environmentally better than oil power. The increasing use of coal in later years is emerging as a considerable problem for the near future, going contra to Japanese environmental commitments.

#### **3.3.4. Electricity**

By 2004 there are 10 electric power-generating companies in Japan, with an integrated high voltage grid for transmission from Hokkaido to Kyushu. Since the introduction of the revised Electric Utilities Industry Law in March 2000 large consumers are free to negotiate prices with any of the originally regionally oriented suppliers.

At the time of the first energy crises oil showed a considerable dominance in the generation of electricity in Japan being the source of 73% of the generation. At the time coal was a long distanced second on 8% with both LNG and nuclear generating a tiny 2% each. With rising oil prices this pattern was set for a through overturn, and by 1990 the share of electricity generated from oil had fallen to 28% and further to 10% by 2002. The change was in reality even more dramatic as during these same 12 years electric consumption increased by 28%. What happened was that the share generated by coal increased from 9% to 22%, while the share for nuclear increased from 26% to 31%. The not mentioned generation, about 12% of production, comes from renewable sources, where hydroelectric dams generate practically 95% of the volume. The large shift that has taken place in the market is that the share of electricity in total energy consumption in Japan has increased dramatically. In 1965 it stood at 15% and was on the decline until the first oil crises, when it suddenly jumped to 25% by the second crises in 1979. It has since continued to increase and stood at around 44% by 2002 (ANRE, 2004-09-04).

As mentioned above it is the household sector that has, and especially will, increase its energy use the most. Perhaps not surprising in a country that already in the early 1990 had more than one air-conditioner per household. Of the 193 TWh consumed in homes in 2001 combined heating/cooling and air-conditioners are the fastest growing of the major items taking 13% and 11% respectively<sup>102</sup>. As a curiosity it could be mentioned that the by far fastest

growing of all items, having existed as a statistical item for less than five years, is “*toilets with wash shields*”, using 3.5% of household electricity (METI, 2004-08-12). Another trend in the Japanese electric market is that private consumers are encouraged to convert houses to become fully electrically heated, which is completely in contrast to policies in most European countries (e.g. Tohoku, 2004-09-04).

For the future there will be an increase in the use of nuclear energy, including the re-commissioning of some generators still under repair. Together this will lift the share of nuclear energy from 34% in 2000 to about 41% by 2010. The proportion of electricity generated from oil would during the period until 2010 fall from 11% to 6% at the same time as the LNG share will fall off slightly, from 26 to 24%. Also the share for coal is planned to fall slightly, from 18% to 16% compared to the year 2000 figure (METI, 2004-07-03).

### **3.3.5. Nuclear**

In 2004 Japan has 54 nuclear power stations that supply about 35% of the country’s electricity.

The Natural Resources and Energy Agency has in its long-term outlook, from late 2003, suggested the building of ten new nuclear reactors by 2030 (ANRE, 2004-07-12). At the same time the Advisory Committee for Natural Resources and Energy, an advisory panel to the Minister of Economy, Trade and Industry, has in its latest draft lowered the projection of the number of reactors that would start operations by fiscal 2010 to four, less than a half its initial target. The construction of nuclear reactors will partly depend on demand and taper off after peaking in fiscal 2021. Apart from the fact that reactors generally have shown stable production results at low costs /kWh, the sourcing of raw uranium has over time proved to be a relatively unproblematic market. That is both in regards to security of deliveries and prices, and especially so compared to other energy sources.

The running of nuclear plants in Japan has been followed by a large number of incidents and smaller accidents, often the result of faults in maintenance. Some of the errors that have occurred have been on the brink of becoming major accidents. What was, probably, the worst occurred in 1999 at Tokaimura where human errors resulted in two dead and a large evacuation of nearby residents. A number of other incidents, including a closure of 17 plants for security checks in 2003, have had a clearly negative influence on a previously relatively strong public support for the large-scale domestic nuclear program (Commondreams, 2004-08-10).

Heavy investments have also been made to create a fuel cycle and a full scale reprocessing plant has been build in Rokkasho, near Aomori, on northern Honshu. Also this plant has had a history of cost over-runs and production problems, but shipments of spent nuclear fuel to the plant was restarted in the summer of 2004. At the time the plant had been closed 20 months for maintenance, due to leaks caused by welding defects. It is hoped that the full scale reprocessing can be restarted during 2006, and by then some 1 600 tons of spent nuclear fuel will be stored at the plant (JT, 2004-06-06). The perspective plan suggests that it should become possible to complete a nuclear fuel cycle at Rokkasho. This will be achieved by way of upgrading the spent fuel for future use, mixing-in plutonium-uranium oxide fuel to create MOX. This MOX fuel will then be used for power generation under the pluthermal program, alternatively in a future, still to be fully developed, fast-breeder reactor (JNF, 2004-09-01).

### **3.4. Transport**

Being a relatively large country in terms of surface, with 377 000 km<sup>2</sup>, Japan is still spread out over four major islands. Of the available surface only 25% is considered to be suitable for human habitat, mostly due to its topography. With a population of about 128 million population density comes to well over 1 300 km<sup>2</sup>, if only the inhabitable land is taken into consideration. As a result, the space available for transport and infrastructure is severely limited in many areas. Also on the remaining  $\frac{3}{4}$  of the surface, road and rail construction faces great difficulty in overcoming, or drilling through, numerous and high mountains and bridging uncountable rivers and canals for rise farming. Additionally, weather conditions, with frequent strong typhoons as well as several metres or snow in winter in other areas, forces into place width of bridges, protections against landslides, man made wave breakers outside ports and so on, that for nearly 365 days of the year can look un-necessary. Together these are factors that considerably raise the cost and difficulty of infrastructure project. Additionally the sharp competition for land not only raises costs further, but also makes projects face intense scrutiny.

#### **3.4.1. Railway**

The international profile of the Japanese railways is beyond doubt carried by the Shinkansen high-speed train system. On October 1 1964 the first Shinkansen train departed on the 553 km Tokyo and Osaka line, just in time for the Olympic games, and celebrated its 40 years jubilee in 2004. Since its inauguration Shinkansen trains have carried 4.16 billion passengers and run over 1.5 billion

km; a distance that is long enough to circle the globe 38.000 times. It has maintained its popularity over the years and carried 360.000 daily passengers in 2003. Even more impressive is the average delay during 2003, which was kept on the level of seconds, and still most impressively of all – with a history that is accident-free. That while running a system with high speed trains reaching beyond 300 kph in a country with a large number of both weak and stronger earthquakes yearly (RTRI and JR, 2004-10-01) <sup>103</sup>.

Railway construction in Japan started with English equipment and even paid for by railway bonds issued in the UK. Opened in 1873, 29 km of narrow gauge tracks connected Tokyo with Yokohama, which was one of the few ports open to foreign trade at the time (JRTR, 2004-07-07). Expansion was very rapid and already inside 20 years the railways from Tokyo reached across Honshu, north to Sendai and beyond Kobe. During its early build-up period all the major Japanese railways were state controlled, with a large number of regional train lines being private, but nationalized in 1905. The next important year was the US led reorganization into a public corporation called Japan National Railway (JNR) in 1949. The state dominance was finally ended with a reorganization into a number of regionally oriented companies in 1987. Still the Japan Railway (JR) Company is the holding company for the six railway operators and the three service companies (Japanrail, 2004-09-01). Of the six railway companies three have been listed on the stock exchange.

At the end of WWII few other means of transport than railways were available and the dominance of the railways stood at 92% in 1950 when measured in passengerkm. With the introduction of more cars the share fell constantly during the coming decades, standing at 76% in 1960, 49% in 1970 and 40% in 1980 (JRTR, 2004-07-07). At the later year car ownership was already widespread, but due to the limited availability of parking commuting by train in combination with the continued popularity of Shinkansen kept, and has since kept, the share for trains relatively high.

As a result of the domestic development of high tech rail equipment Japan has a number of internationally well known producers have been able to attract high profile export orders. One such example is the USD 12 bn upgrading of rail routes in China where the ministry of railways in China has been taking in tenders. The Japanese-Chinese consortium will upgrade tracks and introduce new equipment to make it possible to increase train speeds of up to 200 kph. The project includes five routes that are to be upgraded, totaling about 2,000 km, including those linking Beijing, Shenyang, Jinan and Qingdao (CW, 2004-07-30).



Also the Shinkansen train has found its first export order with the first train being shipped to Taiwan in the middle of May 2004. The Taiwanese high-speed rail system is scheduled to go into operation in late 2005. This was the first of 30 trains that are to be delivered according to a contract signed with a consortium led by Mitsui & Co. This first export contract for the Shinkansen has been valued at about USD 12.7 billion in hardware for the rail manufacturers (Mitsui, 2004-05-19). Trains on the 330-km high-speed line being built in Taiwan will make the trip between Taipei and Kaohsiung in 90 minutes, instead of the four hours needed today. The export of the system has not been unproblematic, as the Taiwanese buyer has decided to partly run the train on a single track, which is never done domestically. Fundamentally changing the signaling system needed, which could well come to delay the introduction of the train (JT, 2004-12-14).

### **Freight**

Due to the lack of other means of transport after WWII the railways held a 52% share of transport work in 1950's, which consequently fell to 39% by 1960. This was just the beginning as it was in the following years that the real crises for rail transport were to set in, with increased truck production and much-improved roads. Rail freight lost out dramatically during the coming years and saw its share in transport work fall to 18% by 1970 and further to 8% by 1980 (JRTR, 2004-07-07).

Jr freight is one of the three service companies inside the JR Group that was formed as a result of the 1987 privatization. Freight on trains in Japan has not been able to maintain the volumes like in many other countries, as the interaction of cargo over land, at long distances, has never come to be established here. Japan also lacks a long distance basic bulk flow of e.g. coal that could boast ton-km figures. Currently the variety of goods transported is not as big as in other countries. It is tank wagons and containers that can be seen on trains although seldom of international TEU standards. Instead a domestic size container, in the size of 0.5 TEU, suitable for local distribution, is what is favored on the railway (Jr freight, 2004-09-01). Efficiency is high and somewhat unique is the handling of containers on trains without shunting, which greatly enhances the efficiency of container transport and minimizes waiting times.

### **3.4.2. Road**

During the years of the 1950's and 1960's the situation in Japan when it comes to roads, was in certain aspects similar to the present situation in Russia and China. In the years after WWII there was practically no cars available and the share held by cars in total passenger transport work stood at only 7%. With the

introduction of more cars the share increased constantly during the coming decades standing at 15% in 1960, 39% in 1970 and to 48% in 1980 (JHPC, 2004-07-07). A rapid growth in private car ownership filled the few roads available and the growth exceeded the efforts made by the state to extend the network. The first toll-roads in Japan were introduced already in 1952 and much of the financing for new roads came from the petrol tax that was introduced in 1954 (JHPC, 2004-07-10). The building of new roads in Japan has been facing all the physical restraints mentioned above. The limited space available has meant that much construction work for new large roads has been forced into tunnels or up on pillars through build up areas. The construction industry has also been given a reputation of having formed a strong lobby that has effectively been promoting the launching of new and expensive infrastructure projects. The industry has in return proved very generous with financial support to political parties.

In all there are about 1.2 million km of roads in Japan, with about 7 300 km of motorways and 53 000 km being national roads. The largest part of the road system falls under the municipalities, 980 000 km, out of which 74% is paved (JHPC, 2004-07-10). In 1957 the cost of construction for the first motorway, between Nagoya and Kobe, stood at 0.6 bn/km having risen to about 5 bn/km for the projects about to start. The national motorways have in later years been under discussion to be converted into three private companies, with a new law being established in June 2004. The law call for the JHPC to be split-up by into three companies and with the privatization decision to be taken in 2006. As driving force to speed up the preparation of the law, was a 2003 scandal that emerged inside the JHPC with “*creative bookkeeping*” having made the financial results during some years look much better than what had actually been achieved<sup>104</sup>. The political resistance against privatisations in this field remains strong and if the Prime Minister will really be able to follow through his intention has been put in doubt.

#### **- Local motor industry production**

Car production at a larger scale came to a start in the years after WWII, being based on licenses granted by French and British manufacturers. Initially both capacity and demand were limited but by the late 1960's both factors had improved greatly and the first export of Japanese cars overseas was initiated on a small scale in the early 1960s. Car production in Japan later came to top at 13.3 million in 1990 and has since been on a slow decline, except for a minor increase in 1996 and 1997, and stayed below 10 million (Japan Automobile, 2004-07-10). During 2004 domestic production has been increasing again, with about 3%, to just over 10 million (ibid., 2004-12-28). Vehicle sales in Japan also peaked in 1990, with 7.7 million units, but have since fallen to a level around 5.7 million for fiscal 2003. Domestic sales of cars for 2004 reached 3.4 million, down 1% on 2003 with

truck sales reaching 550 000 (JADA, 2005-01-05)<sup>105</sup>. Exports of vehicles from Japan topped already in 1986, with 6.7 million units exported. It then fell off to reach its lowest point in 1996 with 3.7 million, but has increased again to about 4.7 million in for 2003. A volume that corresponds to practically half the shipped volume of new cars in the world during the year (MOL, 2004-09-29).

Japans biggest auto producer, and the worlds number two producer, is Toyota. Including subsidiaries Daihatsu and Hino, Toyota produced 6.8 million units during its 2003 fiscal year, at 12 domestic plants, and its 51 other plants in 26 countries/locations with 260 000 worldwide employees (Toyota, 2004-06-20). The model that has symbolized Toyota more than anything is the Corolla model, which for 22 consecutive years was the most selling model in Japan, before overtaken by the Honda Fit model in 2002. However, the Corolla made a comeback in 2003 selling 200 000 units to again becoming the biggest selling model, only to be overtaken again during 2004 by the Honda Fit model, selling 150 000 units. Despite producing the best selling car Honda is second in size, producing about 3 million units at 6 car plants in Japan and at another 10 in other countries, with 130 000 worldwide employees (Honda, 2004-06-20). Nissan is Japans third producer with 2.7 million units during 2003, with 6 car plants in Japan and 15 overseas, employing about 130 000 (Nissan, 2004-06-20). Next in size is Suzuki that produced 1.8 million units from 3 domestic and 7 overseas production facilities, employing 14 000 in Japan (Suzuki, 2004-06-20). Number five in production volume is Mitsubishi that produced 1.6 million units from 8 pants in 6 countries, employing about 11 000 in Japan (Mitsubishi, 2004-06-20)<sup>106</sup>.

The motor industry in Japan is not only big it is also highly innovative. A good example of this was given at the most prestigious “*International Engine of the Year Awards*” in 2004 when the Toyota Prius hybrid motor concept won a record breaking three out of eleven awards. The engine, produced in earlier versions since 1997, was given the title “*truly remarkable*”, by the international motor journalists that voted for the award. With the launch of the new engine, sold in about 230 000 cars already, Toyota will be the first manufacturer to offer a hybrid engine in both passenger cars and SUV’s (autointell, 2004-05-26).

After having started to export from domestic plants all the major Japanese companies have invested heavily abroad. Japanese producers were also among the first to understand the coming might of the Chinese market and have enjoyed many of the early mover advantages in this market. Over the last year a new battle between Japanese producers, Suzuki and Daihatsu, is being staged in India where Suzuki for years have been the biggest producer. Investments in the USD 200 million category, by first Korean Hyundai and then Daihatsu during 2004, has forced also Suzuki to upgrade its capacity in the Indian market (Hyundai, Daihatsu, Suzuki, various dates).

#### **Russia and North East Asia - in times of globalization**

### **3.4.3. Water transport**

Being an island nation with a 34 000 km coastline, with what is topographically a very difficult landscape, water transport has always been an integrated part of the national transport structure. The coastal traffic with rapid long distance ferries continues to play an important part in the national transport network. All islands are now connected, with bridges from Honshu reaching both Shikoku and Kyushu and the worlds longest and deepest railway tunnel connecting Hokkaido in the north<sup>107</sup>. Infrastructure that has increased the national transport efficiency, but has also resulted in a dramatic decline of the ferry sector.

The two by far largest high sea shipping companies in Japan are MOL and NYK, with the two being the second and third largest shipping companies in the world with a fleet of 24 million dwt and 20 million dwt respectively (Lloyds, 2004-10-12). Both companies control approximately 300 ships by way of direct ownership, additionally a large number of ships are controlled by way of different forms of charter. Both companies are the result of a number of mergers over their 120 and 130 years of existence respectively. NYK was the first in Japan to take up international linear shipping with the first line connecting Yokohama with Shanghai already in 1875, and the first long distance line, to Bombay, coming into service from 1893. In 1965 the first specialized car carrier was introduced by MOL, and with NYK sailing the first fully containerized ship to the US in 1968. From this time the two has developed into what today is companies owning a liner fleet with a capacity of about 180 000 TEU each, with NYK having the smaller average ship size of the two. The liner shipping section for the two has now reached a scale where the NYK ships are largely sailing as a part of the Grand Alliance and the MOL group is a participant of the The New World Alliance (MOL and NYK, 2004-11-09) <sup>108</sup>. Both companies have many more ships under order, with eight of these for NYK to become among the largest in the world with a 8 100 TEU capacity.

Although container shipping is the most high profile in this line of business, liner services only constitutes about half of the business for NYK and about a third for MOL. Still, both companies have many ships in tramper service (contracts for one or just a few voyages) with other used for long-term contract shipping, accounting for the remaining part. Ships used for contract shipping are normally specialized vessels, but also include a large fleet of both bulk carriers and crude carriers. In practically all sectors the two are among the largest shipping companies in the world with the dominance for dry bulk carriers being the largest, where MOL is the largest in the world with 9.5 million dwt, at the beginning of 2004, with 7.8 million dwt in the NYK fleet. NYK being the biggest in car carriers 76 ships against 65, with MOL the bigger in LNG, 27 against 14, and for tankers with 11.7 million dwt against 8 million dwt.

Third biggest shipping company in Japan, K-Line, is in the number of owned container ships even bigger than the others, with 197. In number of car carriers it is also bigger, with 63, but has a smaller fleet in other segments. As for the other two, also K-line operates a lot of ships outside of what is actually owned by the company, but still under its control through charter contracts or ownership of companies (as well as individual ships) in co-operations with other companies. As such contract can be both long- and/or short term the controlled fleet of a shipping line can be relatively volatile over time (combined from Clarkson, Lloyds, and Fearnleys, 2004-10-12).

### **Shipbuilding**

Shipbuilding in Japan has a long tradition, with e.g. IHI Marine having a 150 years tradition. However, Japanese shipbuilding was long a highly fragmented business, with most yards building smaller vessels. The first wave of restructuring came with the first oil crises in the beginning of the 1970's. The latest wave of mergers came as late as in 2002 when two new larger corporations were formed. There are currently five major corporations that compete on a global scale inside most lines of shipbuilding. The three long time shipbuilders Mitsubishi Heavy Industries (MHI), Mitsui and Imabari, and the two newly formed IHI Marine and Universal. The two latter formed from a merger of IHI's shipbuilding and Sumitomo Heavy Industries, while Universal was formed by a merger of NKK Corporation and Hitachi Zosen Corporation. Together these five currently operates 15 shipyards for new-buildings, with facilities capable of producing any kind of ships in all sizes in use in the world fleet. The yards have attempted to focus on innovative design and product development to compensate for higher wage costs. So far this has largely made it possible to attract a sufficient number of orders, with the inauguration of a brand new yard for Imabari, with a 500.000 dwt dock as recently as in 2000, serving as a strong indication of optimism. The different yards are located on all islands of Japan, with a concentration to the Inland Sea area, with all but Imabata being headquartered in Tokyo (MHI, MES, Imabari, IHI, Universal, various dates)

With the success of Korea shipbuilding Japan has been overtaken in later years as the worlds leading nation. The world's biggest shipyards are currently to be found in Korea and in 2002 Korea passed Japan, for the second time, as the worlds largest ship producer. Out of a total world ordering of 43 million CGT during 2003, Japan secured 29% of orders while Koran shipbuilders secured 35% of the volume (Fearnleys, 2004-03-07). The trend has been further reinforced during 2004 with orders for about 9 million CGT being placed in Japan, and nearly twice that volume, or 18 million CGT, in Korea (KOSIP, 2004-12-25). Both countries shipbuilding industries have been facing the same economic problems during 2004, where both supply problems and dramatic price increases for first

of all steel has severely reduced the profitability in the industry (MHI, MES, IHI, various dates). The signing of orders at the yards over the year has been upbeat and few new-building slots are currently free for delivery before 2008.

#### **3.4.4. Aviation**

The international airfreight volume in Japan is to over 70% concentrated to the Narita International Airport some 60 km east of Tokyo. In a time when economies in the surrounding world are growing, so is the volume of airfreight, which here contains a large share of electronic appliances. Between 1986 until 1996 the cargo handling at Narita was the largest in the world, when the top position was taken over by Hong Kong, but Narita has remained second in the world since (Narita Airport, 2004-07-20). 1.1 mt were handled during H1 2004, with the full year volume having been estimated to 2.1 mt. In the beginning of 2005 the new Chubu Central International Airport is scheduled to open near Nagoya and is expected to take over some air cargo from Narita destined for central Japan. Currently some 60% of cargo destined to this region of central Japan is being handled at Narita. The sheer size of Narita is also its strength, as it daily operates some 470 international flights to near 100 cities in the world. For the future volumes are expected to increase considerably, with capacity at Narita being increased to 2.4 mt during 2004, while volumes are expected to exceed 3 mt by 2012.

In the total turnover figure of freight Narita is about three times as large as its closest competitors, Osaka and Tokyo Haneda, which handled 790 000 and 722 000 tons during 2003 respectively. Volumes that placed the two as number 23 and 24 in the world (ACI, 2004-12-01).

On the passenger side, the by far biggest airport in passenger numbers is the central Tokyo Haneda airport, ranking fourth in the world after Atlanta, Chicago and London with a turnover of 63 million, up by 3% over 2003 (ACI, 2004-12-01). The opening of a second terminal at Haneda in December 2004 allowed the two main airlines, ANA and JAL, to use separate terminals, which should mean further increasing passenger volumes in the coming years (JAT, 2004-12-01). The previous single terminal was designed for 40 million, had allowed for only 60% of passengers to board from the terminal and the remaining by bus, which now will change to 90%. The two airlines have also shown other signs of good (?) co-operation, as out of 140 bids for domestic postal transport that the two had placed, 115 bids happened to be fully identical (Kyodo, 2004-12-12).

Outside of Haneda, Narita has been about the 25<sup>th</sup> biggest of the world's airports during the last ten years, having seen about 23 million passengers during 2003, a fall by near 9% compared to the 2002 figure (ACI, 2004-12-01). Competition among airports will increase in Japan during coming years as the Osaka Kansai airport has decided to reduce landing fees by 90% from early 2005 to attract more domestic flights, with a new Central Japan International Airport to open in Aichi Prefecture (Nagoya & Toyota) for the World Expo in February 2005. Already in 2006 a new Kobe Airport is to open in between the two mentioned (JT, 2005-01-27).

## **3.5. Other**

### **3.5.1. Iron and steel**

Between the years from 1950 to 1980 Japan was the world's third largest producer, but overtook the US in the beginning of the 1980, when the US volume started to dwindle and the Japanese stayed more or less flat. Then, with the falling apart of the Soviet Union, Japan became the world's largest crude steel producer in 1991, only to be overtaken by a rapidly expanding China in 1996. Production volumes have over the last 30 years been maintained over or near 100 mt y, with highest volumes being produced in 1973 – 1974, 1980 and 1990, with 120 mt, 116 mt 115 mt respectively. Average production costs for basic steel products in Japan in 2003 were estimated to be highest among all major producer countries, and among the highest in the world. Only the US of the larger producers are estimated to have about 5% higher average costs, while among producers in the NEA region Japanese costs are set about 20% above that of China (combined from IISI and WSD, various dates).

The first major crises in the Japanese steel industry came in line with the general economic crises triggered by the oil crises in 1974. From rapid production expansion until the middle of the 1970's, the coming years was marked by price war and downsizing. Nippon Steel, e.g., produced over 40 mt in 1974 and had to reduce its volume by over 25% in the coming years. As a result of the crises of the 1990's the consumption of steel in the domestic construction industry collapsed at the same time as the government scaled down its public works. Further downsizing followed and later another price war commenced among desperate producers. A merger between the then second and third biggest producers, NKK Corp. and Kawasaki Steel Corp., forming JFE Holdings Inc. was conducted in September 2002. With a combined production of near 30 mt the two are nearly the size of Nippon Steel. Nippon Steel, on the other hand lined up with Sumitomo Metal Industries Ltd. and Kobe Steel Ltd. through a minority

cross-ownership, later the same year. As a result of this the market suddenly had been restructured from five to practically two key players. This new market structure allowed the producers to regain much of its lost bargain power towards both consumers and suppliers, at the same time as it was facing a market in slow recovery (NS, JFE, SMI, KS, various dates)<sup>109</sup>. Measured in production capacity of crude steel the biggest producer in Japan 2004 is Nippon Steel, followed by JFE Holdings Inc., Sumitomo Metal Industries Ltd. and Kobe Steel Ltd.

Japan's iron and steel industry has during the last two years shown signs of strong recovery as crude steel production 2003 reached 111 million tons, which is the highest since fiscal 1990, and the fifth highest ever. With total production having increased by near 3%, production is increasing the fastest in the special steel category with near 9%, to reach a volume of 22 mt, with ordinary hot rolled steel making up 82 mt. Domestic steel consumption for 2004 is estimated to exceed 70 mt, highest in four years, but still export markets remain very important for the Japanese steel industry. Of the 35 mt exported during 2003, Korea was the destination for nearly 30% of the steel export, with Korea also being the most important origin of the 6 mt Japan imported during the year (JISF, 2004-08-15). Production during 2004 has increased slightly from the 2003 level, near the capacity of the industry, at the same time as prices has been on a clear upward trend during the period. As a result, the steel sector, which was in deep crises a decade ago, now expects record profits for fiscal 2004, but is fearing the price increases that will be necessary to cover cost rises in 2005 (NS, JFE, SMI, KS, various dates).

Just a few years back the steel industry was under pressure to make further reductions of production capacity, but the boom in the Chinese market has come to postpone this. The demand from Chinese consumers became real strong from about 2000 and onwards, but the latest recovery is also a result of increased domestic demand. The Chinese demand has been for wider uses in infrastructure building and social infrastructure, while domestic demand has been increasing the fastest from car producers and from shipbuilding. From the steel industry the strong demand is not expected to fall off until after the Olympics in 2008 or possibly until after the Shanghai Expo in 2010 (JISF, 2004-08-15).

Steel producers have over the last decade become increasingly involved in FDIs in attempts to acquire both production facilities and raw material. Although companies have adopted different strategies, FDIs in e.g. Brazil, Australia and Africa has generally focused on the development of new coal and iron ore findings. However, large investments have also been made in the Chinese



market to secure a foothold in production facilities and to develop new products. The so far most advanced step in this direction was made by JFE Steel in 2004 that plans to construct a new blast furnace steel mill integrated with a steel work in the Guangdong Province. It will be producing high quality flat-rolled steel for the car industry as its main end product. When opened, it will be the first Japanese furnace build overseas since the end of WWII (JFE, 2004-08-12).

New in the industry is also its increasing dependence on the Chinese market, exemplified above, but Korea still remains the by far largest export market. These foreign markets remain under close observation as exports have grown rapidly over the last few years, and a possible restructuring could be up coming already in the medium term on the Chinese market. With a demand of over 250 mt also a fall in demand of just 10% in China would equal the production volume of one of the two largest Japanese producers and will be strongly felt in the market. For the moment, however, all major Japanese producers are harvesting record profits and expects demand to remain high for the time being among its most important domestic customers like shipbuilders and carmakers as well as on overseas market. If also domestic private investments will start to increase, as a result of the ongoing economic recovery, that would come as a bonus for the producers.



## 4. China

### 4.1. Introduction to China<sup>110</sup>

The future of China is under the current development, getting ever more closely connected to, and interdependent with, developments in the surrounding world. Still China, in its position as one of the world's leading powers, pursues an independent foreign policy based on five basic principles: mutual respect for other countries sovereignty and territorial integrity, mutual non-aggression, mutual non-interference in internal affairs, mutual equality and benefit, and peaceful coexistence in developing diplomatic relations and economic and cultural exchanges with other countries. At the same time as fundamental changes to the previous system will be described in this chapter, the constitution indicates continuity:

Article 1 of the Chinese constitution, adapted in December 1982, reads:

*“The People's Republic of China is a socialist state under the people's democratic dictatorship led by the working class and based on the alliance of workers and peasants. The socialist system is the basic system of the People's Republic of China. Sabotage of the socialist system by any organisation or individual is prohibited.”*

(Xinhuanet, 2004-04-20)

Furthermore the constitution's first paragraph gives the power to the people, exercised through the National People's Congress, under the principles of a democratic centralism. Meanwhile, Article 6 of the constitution is probably the one that has been most clearly surpassed by the development in recent years as it reads:

*“The basis of the socialist economic system of the People's Republic of China is socialist public ownership of the means of production, namely, ownership by the whole people and collective ownership by the working people. The system of socialist public ownership supersedes the system of exploitation of man by man; it applies the principle of 'from each according to his ability, to each according to his work.’”*

(Xinhuanet, 2004-04-20)

China is in the early 21<sup>st</sup> century the world's most populous country and has an economy that is demonstrating a long-term economic growth at an unprecedented speed in its history. It remains a country based on a Socialist democracy, and this has not stopped it from launching far reaching reforms in

many fields. Most of the larger companies are still state owned or, if partially privatized, the state remains the owner of a controlling share. Despite the fact that, China now has many fully private large companies, which could be seen as against the constitution, it has also received innumerable FDIs and offers both “*special economic zones*” as well as generous tax and tariff breaks to foreign investors. Still the restructuring of state enterprises has so far proceeded slowly, but has nevertheless come to result in staff reductions on a grand scale on occasions.

In many respects 2003 was an unusual year for China as it experienced a transition of power at the Party Congress in March, when former president and chairman of the ruling Communist Party, Jiang Zemin, resigned in favor of Hu Jintao. At the same party congress Wen Jin was named new prime minister.

#### **4.1.1. The Chinese Economy**

As in many other countries, the main focus of politics in China is to improve people's lives and to adjust the problems that arise from disparities between the rapid economic development and the often-slower social development. Opinions on the means needed and the speed these problems should be attended to can vary greatly based on the political standpoint of the decision-maker or observer. However, despite the fact that practically every economic indicator has remained positive for many years now the disparities in the society are increasing. The distribution of the benefits obtained from the positive growth figures is a continuous problem of by the central authorities. So far there has been little balance in the distribution neither between different regions nor between social groups, and instead income gaps between social-strata of the population are widening. This is especially seen not only in western but also central regions of the country, which have been falling behind not only in income terms, but also in educational and health terms. Cash rural income level remained at about 1/3 of the urban level, that stood at about USD 1 050 by mid-2004. There is an understanding from Beijing that a coordinated, yet sustainable, development must be upheld to generate surpluses that can be distributed. The long-term plan suggests that the country should at least triple its GDP by 2020, while the prescribed path for this growth is oriented towards a regionally balanced development. For the future stability of China, it will be crucial that these aims can be fulfilled to guarantee more than a subsistence income and development for its population, including a considerable degree of social fairness.

It is beyond doubt that the reform path followed so far by China has been successful, at least if the measurement used is GDP growth. China's economy has expanded by a factor 45 over the past 25 years and much of that development has been made possible by the profits earned from free trade. Over these 25 years, average per capita GDP has increased from less than USD 200 to over USD 1 000, with an increase in life expectancy from 61 to 71 years (ESA-UN, 2004-05-10). As China has come to base much of its economic development on exports, this has also increased both the dependence and the exposure to changes in the international economy in a way never seen previously. Internationally, this is not unique, but in the future China will not be a nation that can retreat to the use of its own resources for development and will hardly be able to reverse its development to follow any kind of socialist principles of self-sufficiency.

According to international sources, such as the IMF and the ADB, Chinese exports will remain strongly vibrant, but there are fears of a possible overheating and at some stage investments will have to come down. A controlled appreciation of the Yuan has been suggested as a way to cool down the partly overheated economy, while allowing increased imports, to surpass exports in value, could be a way to shrink the current-account surplus.

China, over the past 25 years, had an average GDP growth of over 9.4% and the growth is expected to be maintained around 7% for the coming 15 years, according to Vice-Premier Zeng Peiyan (CD, 2004-09-13). In 2002, the Chinese GDP, for the first time, passed the benchmark CNY 10 trillion level reaching 10.3 trillion, up by 8% over the year before. During 2003, China managed to stop the threatening SARS epidemic and at the same time, despite the epidemic, reach a 9.3% GDP growth. The strong growth of GDP during the year, totaling 12 trillion Yuan (USD 1.4 trillion) made the per-capita income pass another benchmark of USD 1 000 for the first time<sup>111</sup>. According to the Ministry of Economy, the national GDP/capita by 2020 is estimated to have reached over USD 3 000 and combined GDP to have passed USD 4 trillion. In economic terms, the primary sector in China contributes about 14% of GDP, construction and industry to 55% while the service constituted above 31% (Bofit, 2004-44). The growth level for the three sectors was 2.9%, 9.9% and 7.3%, respectively, which indicates that the share of the secondary sector, industry, is still growing as the fastest, despite its already large share of the economy. There are probably some statistical problems involved here, but it is clear that the large surge in the service sector that usually follows after a country has seen its industry expand, still awaits China (CEC-CEDA, 2004-09-20). For 2004, the country's GDP grew 9.5% to 13.7 trillion (USD 1.6 trillion) (NBS, 2005-01-25). A slight slowdown, especially during Q3 of 2004, was seen as a product of reduced bank lending and

restrictions to investments in overheated sectors (CW, 2004-11-03). Overall fixed investments slowed by one percent during 2004, to 26% percent, but were restricted considerably after having increased by 43% during Q1 2004 (NBS, 2005-01-24). Total industrial production during 2004 increased by 11.5%, down from 17% in 2003, while production in companies with foreign ownership grew by over 20% (NBS, 2005-01-24).

With increasing living standards and incomes, the Chinese consumer goods market is becoming increasingly important with consumer good sales for 2004, having increased by 10% in real terms, to 5.3 trillion (USD 650 bn), and with overall sales passing 15 trillion (USD 1.8 trillion) (BNS, 2005-01-24). However, the figures for the latter part of 2004 indicates a lowering of the increase in domestic demand to a one digit level, which, together with a stabilization of consumer prices, could indicate future sustainability of the general growth (WB-Ch, 2005-02-02). Although consumer prices rose by 3.9% in 2004, 2.7% more than 2003, driven by an above 10% increase in food and fuel prices, there was a slowdown in the later part of the year. The sharpest rise was seen in rural areas where prices were up by 4.8%, but by only 3.3% in urban areas (NBS, 2005-01-25). One of the big shifts in the consumer market is that both the product types and the price level of goods have risen dramatically as new consumer durables, foreign travels, cars and apartments are included in the consumption pattern for many more. Consumption figures that are supported by rising disposable incomes that for rural residents increased by average 16% and 12% for urban residents during the first nine months of 2004 (NSB, 2004-09-14). This pattern can be expected to be maintained, for at least the near future, as the Chinese consumers have a positive view on both employment and incomes in the longer term (NERI, 2004-09-13). If the planned economic development can be maintained, then the Ministry of Economy predicts that there will be about 100 million of middle-income families in China by 2010, each holding assets of at least USD 70 000. In continuation of this development, the Chinese market will be second only to the US by 2020 (China Economic Net, 2004-09-20). In the meantime, China's consumption remains relatively small, about similar in size, in relation to the share held by investments. As indicated above, this will become increasingly better balanced by a fast growing consumption, which in the future will contribute to a reduction in the level of export dependence.

The framework for China's next stage of development is indeed encouraging with the national GDP increasing rapidly, it will have dramatic effects on the living standards and settlement patterns. The level of urbanization will, by 2020, have reached 55%, from 37% in 2003, and urban areas will then house a population of about 750 million. By 2020, it is hoped that the country will have come to terms with both energy and resources consumption, and that both will show a zero growth level, and as a result, ecological deterioration will start to

decline (CAS, 2004-03-06). If the estimations of future migration flows will prove correct, then it would mean that the country will see over 200 million new city dwellers in less than a generation; that in a county that already in 2004 had 22 “second cities”, mostly inside 300 km off the coast, with a population above 2 millions. This one-sided development strategy, with a strict focus on increased production volumes, has included excessive consumption of both energy and other resources, often resulting in considerable environmental degradation. For every USD in GDP generated, Chinese producers need four times the energy, compared with US producers’ need for the same production volume. If environmental degradation is taken into account, the GDP growth in the 1985 - 2000 period would be reduced to about 6.5%/year (SEPA, 2004-09-02).

Despite all the positive factors having been mentioned above, there are also some worrying signs on the horizon related to both domestic and international concerns. However, economic growth in China and the Asian region could be expected to stay higher than world-average, but is unlikely to perform on the level of 2003 and 2004 in the near future. With an orientation mainly focusing on GDP growth through promoting economic efficiency and increasing productivity, the social side of development has partly been overlooked. Internally, China's economy has been developing very unevenly in the regions, at the same time as it has long been developing dangerously close to being overheated elsewhere. The diversity inside the country and its size can be reason to question especially economic statistics presented. In 2005, the NSB wants to increase accuracy in its reporting and the “*First National Economic Census*” will be undertaken with 10 million census takers about to visit 35 million companies and institutions. It is expected to cover about 85% of all economic activities with information to be directly fed into the planning for the 11<sup>th</sup> Five-Year Plan for 2006 – 2010 (NSB, 2004-12-19). Companies are generally doing well and based on the financial results of the 100 largest companies in China, the rating company S&P (Standard & Poor’s) predicts that growth will continue. Companies in 2003 increased their revenues by 30%, compared to a 14% increase in 2002, at the same time as the return on capital increased from 14% to 16% (CW, 2004-10-29). These figures cover companies that have more or less adapted to international accounting standards, which most companies have not, and with a majority still far away from meeting such standards. However, there are considerable problems with the reliability of the figures produced inside the state company sector, which has been revealed by the Assets Supervision and Administration Commission of the State Owned Enterprises (SOE). Out of 181 revised SOEs in 2004, 80 were found to have had serious asset losses over the last two years that had not been properly declared. This was much attributed to the fact that these companies had used over 300 financial intermediaries that in numerous cases had helped the SOEs to conceal facts (CD, 2005-01-12).

Internationally, but especially in China, there are several insecurities for the near future, like oil and energy prices, but also lower growth in developed countries and future US trade policies. In the same way as Japan came to serve as a scapegoat, to be given the blame for economic problems in the developed world in the 1980s, it now China that has come to take over this role. The valuation of the Rembindi/Yuan is one such issue that is frequently being quoted as a cause of much harm among trade partners (to be further discussed below). The domestic agenda for 2005 is set not only on promoting rural development, but also to continue economic reforms, continuing to internationalize while maintaining social harmony. The goal is to *"maintain steady and relatively fast economic growth with more emphasis on quality and efficiency"* (Hu Jintao, Xinhua, 2004-12-12). To achieve such a target, and to develop the economy in a sustainable way, the Chinese Government must at the same time smoothen out its differences in interest with the outside world.

### **Investments**

In 2002, FDIs in China climbed by 16% over the year before and increased again in 2003 by another 27%, to USD 54 bn and during 2004 by 12% to 61 bn (Bofit, 2004-05-19 & Dow Jones, 2005-01-08)<sup>112</sup>. In 2004, total investments increased by 26%, to a total value of 7 trillion (USD 840 bn) (NBS, 2005-01-25). Urban areas received 85% of these investments and saw a rate of increase slightly above average. However, development has been very uneven in different sectors and agriculture that accounted for only 3% of the total during 2003, investments were up by 4%, while the industry sector showed a 39% growth while raw material processing reached 72%. Focus for investors in 2004 were the service sector that received 60% of investments, with manufacture taking practically the rest. Until recently, FDIs in China focused on manufacturing and only the odd projects was aimed at other sectors, while in the near future, there will be a large inflows of FDIs in other sectors. Banking is not only one such sector that is opening up, but also tourism, commerce and consulting are other examples of sectors that can be expected to attract large FDIs in the future (CSI, 2004-07-10). The state or regional governments were participating in 73% of investments, showing an increase on par with the average. The financing of domestic investments in China was to a third out of companies' own cash flow and borrowing from banks accounted for about a ¼ of the total.

During later year's the FDI flow has been in the range of about 4% of the national GDP, with FDI companies representing only 6 - 7% of total investments, but with a growth rate far above the domestic (Xinhuanet, 2004-10-28). FDIs often go into JV projects with local companies or to privatization of state companies in China, although privatizations have not been as aggressive compared to Russia, it is still ongoing. Of total FDIs, it is Japan, Taiwan and USA



that serve as the most important origins (Xinhuanet, 2004-07-12). Accumulated FDI totaled near USD 2 trillion by December 2004, of which 562 billion have been materialized (MOFCOM, 2005-01-18). By the end of November 2004, a total of over 250 000 foreign-owned companies had been set up in China, with 490 000 companies that includes foreign participation. Out of these 40 000 there were new enterprises having been set up during the first eleven months in 2004. Accumulated inflow of FDI until the end of 2002 from Japan, as China's largest trading partner, had reached 25 000 investment projects, with a contract value of USD 50 bn, of which USD 36 bn (72%) had been realized. At the same time China had seen 14 000 investment-projects from the EU to a total contractual value of USD 61 bn, with just USD 33 bn (55%) having been realized. The same figures for Korea were 22 000 projects to a value of USD 28 bn, with USD 16 bn (57%) having been realized, with the figures for the combined group of ASEAN countries being USD 58 bn, with realization USD 29 bn (50%) of this realized. Since China established diplomatic relations with the US in 1979 until the end of 2003, US companies had invested approximately USD 30 bn in China. During 2003, the US invested a total of USD 4.3 bn in China in about 2 500 different projects, with machinery and oil as the two most important sectors (CD, 2004-09-13). Russian investments in China are relatively small and are expected to reach about USD 800 million in 2004 (CW, 2004-09-18). Another important origin of large FDIs is the worldwide expatriate Chinese population living outside of the mainland. By 2003, it has been estimated to have reached over 60 millions. This group has also been eager to invest in the mainland and have had great advantages in doing so from their linguistic, ethnic and family ties. The importance of FDIs cannot be underestimated as companies involved in FDIs generated more than 10% of urban employment during 2003, 30% of the industrial output and over 50% the export volume (ibid., 2004-08-15). Over 400 of the 500 largest companies in the world ranking have invested in China, with over 30 operating their regional HQ in China (MOFCOM, 2004-09-08 and 12-25).

These are impressive numbers, especially so as China is not given a very high ranking for its general competitiveness. Ending up as number 46 out of 104 in the World Economic Forum's 2004 ranking, with its stable macroeconomic environment being seen as the Chinese strength and the low level of advanced technology as its main weakness (WDF, 2004-10-13). In the authorities, attempts to cool off overheated sectors, over 5% of all projects, especially in steel and cement, has been delayed or scrapped, involving a total of near 4 000 projects. Sectors that have been seriously straining the economy, such as infrastructure and transport, have also been growing well above average. The real-estate market has increased just under the average while ferrous manufacturing, that is seen as overheated, still has raised the most; by 46%. Generally, investments slowed during the first months of the year, but rebounded with growth during

the mid-year period compares to low figures for 2003. In a year with a continued strong FDI inflow, preliminary figures show that investments have started to spread into new regions that previously had seen relatively few FDI (CW, 2004-09-02). In some important regions like Hainan and Fujian, the fall in FDI reached 60% and 40%, respectively during the first seven months of 2004 (China Radio International, 2004-09-03). In contrast, other previously less favored regions for FDIs have seen dramatic increases, as in provinces like Yunnan and Shanxi where the increase has been nearly 600% and 200%, respectively. The regions and the state, including state companies, accounted for about 60% of total investments in these regions, which can be seen as part of state policy to spread the economic benefits into new areas (ibid.).

Although there are a number of regional stock exchanges having been opened in major cities, The Shanghai Stock Exchange was the first to open in late 1990, and is the most influential. This exchange builds on a tradition from the early 1920 when the first security and commodity exchange opened, that had become the trading centre of the Far East by the 1930s. However, the exchange was closed in 1949 to be reopened again 41 years later (SSE, 2004-04-10). By the end of 2003, it had 913 securities and the shares of 780 companies listed, to a combined value of 3 trillion. In 2003, a combined 56 billion was raised by companies over the exchange from the 34 millions holders of an account at the SSE (SSE, 2004-05-30). The problem with the stock exchange is that companies often do not pay dividends, as they are not JSC in a conventional sense, and primarily use the exchange to raise capital. Share values at the stock market in 2004 already peaked in April, and kept falling in value in the rest of the year. By September, values had reached its lowest since June 1999, as measured by the Shanghai index (SSE, 2004-09-10). The development at the second stock exchange in Shenzhen, opened in 1990, much resembles that in Shanghai. Here, 506 companies and 629 securities were listed at the end of 2004 with a total of 250 bn having been raised by companies over the year of operation (Shenzhen, 2005-01-15). With many of the important listed shares at the exchanges belonging to companies in overheated sectors and with Central Bank's credit restrictions for investments, the market cannot be expected to make any major recovery in the near future. A structural problem for the trading is that about 2/3 of the shares of larger companies are not being traded, reducing the influence on the companies from small owners. The lack of influence from minority owners has also been recognized as a problem by the authorities. New legislation should be introduced to increase transparency from the point of small owners, as well as it is expected to allow increased access to information.

The government has indicated its intention to sell its interests in most of its stock companies, but this would flood the market, with the state being the largest owner in a majority of listed companies on the stock exchanges. There will hardly be demand enough to absorb what could triple the supply of shares. So far, the trading of state-owned shares has not been allowed on the exchanges. Near future sales by the state of a variety of companies are instead expected to take place in Hong Kong during 2005, and could be expected to generate some 5 bn to the state coffin. Also, a smaller number of energy-generating companies are expected to be put-up for sales, which will allow its buyers to be among the first to enter into energy generation (HK-esd, 2004-08-25). By the end of 2003, the value of Chinese stock exchanges were among the ten biggest in the world, valued at about USD 400 bn. Having increased its value compared to national GDP to about 25%, from about 1% ten years earlier (Bofit - CR, 2004-1).

### **Outbound investments**

It is not only inbound investments that have increased, but also Chinese companies are increasing their FDIs abroad. Outbound investments, with state sanctions from oil companies, miners and steel makers to secure supply for the future, have also contributed to considerable outflows. The Ministry of Commerce and National Bureau of Statistics has released its first report ever on China's direct investment in overseas market for 2003. The report indicates outflows of USD 2.9 bn from China to foreign markets for the year, or about 6% of the inbound. By the end of 2003, a total of USD 33 bn had officially been invested in foreign markets by Chinese entities. The geographical origin of these investments has first of all been Beijing and other coastal provinces, with Guangdong Province having made the largest investments (PD, 2004-09-08).

### **Banking and monetary policies**

A far-reaching reform agenda for the Chinese banking sector has been initiated and is continuing, but has become a debated topic. The banking sector has long remained more or less untouched in the transition process, with the state banks covering up much of the losses and the bad loans of unprofitable state companies.

In the process of entering the WTO, the differences between laws and regulations in banking and financial services, as well as opening-up for foreign actors, were hard to overcome in the negotiations. Domestic laws should be respected, but a new member is obliged to undertake the changes needed too allow market access. If necessary, this can be implemented during a grace/transition period allowed and written into the final charter. As a result of the increased inflow of FDIs, and the rapid increase in trade, in later years, the banking sector has indirectly been forced to internationalize its operation at an

even more rapid pace than what was foreseen in the negotiations. However, still many laws and regulations, including the major privatisations in the banking sector, have not been sorted out from the governments side, but the sector has undoubtedly made considerable progress. Time is rapidly running out as the WTO membership agreement forces China to open up its banking market to foreign competition by December 2006 at the latest. Already by the end of August 2004, 62 foreign financial sector companies had been established, in addition to 152 foreign banks from 38 countries. Together, these had opened about 220 offices in 22 cities (CD, 2004-09-14). By mid-2004, over 100 of these banks had obtained the right to handle Yuan transactions in 13 selected cities, but foreign banks deposits remained under 0.5% of national banking assets (PBOC, 2004-08-01). However, this is only the beginning of the process and it must be a worrying sign for the state that in a study of competitiveness among banks, by the PBOC itself, the four biggest state banks ended last in the ranking (PBOC, 2004-10-01). There is a lot at stake, as the four largest state banks controlled no less than 70% of the loan market in Beijing.

In the early years of the 2000s, it was generally estimated that some 20% of loans given by the Chinese banking sector was “*non-performing*”, although official statistics sets the figure at about 15% (Xinhuanet, 2004-09-14). What makes this a serious issue for China is the volume of such loans at a time were estimated to some CNY 4 trillions; or half of the GDP (BOFIT, 2004-04-02). In 2004, the volume of the loans declined by near 5% to about 13% of the loan stock among the major banks, or 1.7 trillion, with 1.5 of this held by the state banks (CBRC, 2005-01-28). Unconventional measures have been used when attending to this problem, e.g., when the China Construction Bank (CCB) and Bank of China (BOC) reduced their non-performing loans stock to below 9 % of the total, which is much lower than other state-owned banks<sup>13</sup>. To make this possible the CCB and the BOC each received a USD 22.5 bn bailout from the state in late 2003. The situation is gradually improving as the five state-owned banks reported 16% of nonperforming loans by the end of Q3 2004, which was down from over 20% at the beginning of the year (CBRC, 2004-10-28). The Chinese government has declared that it will inject money into the remaining two of the four largest banks Industrial and Commercial Bank of China (ICBC) and the Agricultural Bank of China (ABC) (CBRC, 2004-12-04). ICBC and ABC have long been regarded as the weaker of China's big four state banks and are both burdened by billions of dollars of nonperforming loans. A number of rural credit cooperatives and four asset management corporations were established by the state in 1999 to administer this kind of nonperforming loans. Assets that at the time had a book value of 1.4 trillion (USD 170 bn) were to be sold to willing domestic and foreign investors. However, this has proved more complicated than initially expected. In late April 2004, the Citigroup announced the purchase of USD 240 millions of

such assets from the Great Wall firm, administrating loans of the ABC (Citigroup, 2004-04-27). It took Citigroup seven months to get an official approval for the deal. However, at the same time, the regulations for such sales were considerably relaxed to speed-up the process and to have the sell-offs completed by 2006 (NDRC, 2004-11-08). In the reform that started in 2003, two examples of future partial privatisations in the banking sector have been indicated for the BOC and for the CCB. The privatization of the two banks is to take place within the next three years and the two should have become JSC by the end of 2006 (CRBC, 2004-09-08). The reform will continue by preparing the ICBC and ABC to follow the same reform path. An indirect confirmation by the market of the reform of the CCB was given when it became the first bank in China to issue a subordinate debt loan in July for 2004, for USD 1.8 bn. The loan was fully subscribed by the market, and the bank will therefore issue a second one. These operations have been done with the aim of raising the capital adequacy of the bank to over 8%, in preparation for its future privatization (CW, 2004-09-13). By the end of 2004, the four state banks held assets of about 16 trillion (USD 2 trillion), accounting for 54% total bank assets in the market (PBOC, 2004-12-26).

To somewhat increase the liquidity in the growing market, PBOC has been slowly increasing the volume of bills it sells to the banks. The liquidity of the Chinese banking market has for long been relatively high, facilitating the impressive volume of investments. The state has in early 2004 issued investment guidelines to banks urging them not to issue further credits to sectors showing signs of overheating. In an attempt to cool down the lending market and indirect investments, the PBOC raised the required reserve rate for the banks from 7% to 7.5% in the summer of 2004 (PBOC, 2004-07-08). Although the general desire to save is strong, the negative real interest rates are likely to have made people spend more on consumption and to search for higher returns from funds, real estate and non-official lending. Higher interest rates will also lead to that the inflow of foreign capital would increase further. At the same time, as there is a risk with higher interest rates as it contributes to further swell the volume of non performing loans, as with more companies could be hit. Higher official interest rates also contribute to increased savings, which could be needed, as over the first eight months of 2004, when bank savings fell. The banking system held deposits of 2.7 trillion by the end of September 2004, which was 0.5 trillion less than at the beginning of the year, with near half having been withdrawn by individuals (PBOC, 2004-10-26). During H1 2004, investment funds grew near explosively as they increased their holdings by 132 bn; 127 bn more than during 2003. Still, real estate was the by far largest receiver of savings as near 300 bn went to down payments for housing, up by near 50% over the same period one year earlier (CD, 2004-1018). In a developed country, real estate or owning a