

The Economy and Development Prospects of the Russian Far East

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INTRODUCTION

The Russian Far East (RFE) constitutes one-third of the territory of the Russian Federation (see Figure 1), and it is two-thirds the size of the United States. Geographically, it is adjacent to China, the Korean peninsula, Japan, and the United States (Alaska). This part of the Russian Federation has great potential for economic growth, because of its abundant natural resources and the high level of education of its people.



Figure 1. Russian Far East territory compared with the Russian Federation

Despite these potential advantages, the RFE is currently in a deep economic crisis. Privatization of former state property has been carried out, but without any real positive results thus far. The economy has continued to decline, and

unemployment has increased. A lot of questions have been raised about the prospects for the development of the Russian economy as a whole and the development of individual regions in particular. The purpose of this paper is to provide an assessment of the current economic situation in the Russian Far East and to estimate its potential for future development.

MODERN MACROECONOMIC SITUATION

The macroeconomic situation in the Russian Federation has become significantly aggravated, ever since the beginning of the 1992 radical economic reforms. The main goal of the reforms was financial stabilization, but this goal has not yet been achieved. The deficit of Russia's federal budget has grown significantly, from 7.5% of the planning budget in 1992 to 16% in 1999. The government has a huge external debt for the nonpayment of wages, state defense orders, and state bond obligations, plus a huge internal debt.

The gross domestic product (GDP) has decreased rapidly, and thus per-capita GDP has fallen. According to official statistics, GDP fell by more than 50% during 1989–96, and per-capita GDP fell accordingly, from \$6,000 to \$4,300.

Privatization is one of the main features of the economic reform in Russia, and 125,400 state enterprises became privately owned during the years from 1992 to 1997.

The State Committee for the Management of State property began to sell small-scale enterprises in the middle of 1992. These small companies included retail shops, petrol stations, hairdressing salons, and so forth. Today the private sector is a dominant part of the economy, and it accounts for more than 70% of GDP.

During the first phase of the privatization the main task was to increase state revenue. The aim of the second phase was the privatization of large enterprises. The third phase had to include effective management of state property and an understanding of the fact that privatization is not the only resource of revenue to support the state budget.

Since the beginning of 1997, the main goals of the third phase of the privatization have been the following (Russian Federation 1997: 62–4):

- to increase the economical effect of the Russian economy and some enterprises
- to attract investments for the industrial, technological, and social development of enterprises and the environment
- to develop a class of owners who can understand the strategy of development, accumulation of capital, and modernization of production
- to decrease the budget's expenses for the management of the economy and for the support of unprofitable enterprises

- to form conditions and rules for the real estate market and states protection for owners
- to protect the population.

Today we can say with certainty that none of these goals has been achieved. Privatization has had more negative results than positive ones in Russia. And one of the main negative results is the inability of managers to operate during the period of the transitional economy. Russia has a lot of enterprises, both large and small, that are either bankrupt or existing on the verge of bankruptcy. They cannot pay taxes, wages, and other liabilities. Therefore, privatization in Russia has exceptionally subjective characteristics and does not satisfy the needs of the national economy and society. After privatization, what remains is industry in ruins.

The same tendencies are apparent in the Russian Far East. The Far East had great prospects prior to privatization. It had an industrial base, which was oriented toward the production of raw materials, and it had a military-industrial complex and fishing industry, including fish processing. There were heavy equipment plants, machine building, ship building and repair, tool construction, aircraft construction, machine tool production and repair, light industry, a construction industry, a food industry (primarily fish processing), and others. And all of these sectors of the economy were growing.

Then the economic crisis began in 1991, and the value of products began to decrease at the beginning of 1992. Gross domestic product declined by 28% from 1991 to 1996. Russia had not experienced such results even during the First World War, the Civil War, or the Second World War. Industrial production in the Russian Far East in 1992 has been estimated at 93–95% of the 1991 level, but the real decrease was greater than this estimate. Today, the only active enterprises are the food industry and construction. In practice, the heavy equipment plants are not operating. Recent production dynamics for 1996 and 1997 are shown in Table 1, and a reference map showing the administrative divisions is provided in Figure 2.

Table 1. Production dynamics of large and medium-size enterprises, in percentages relatively to the same period of previous year, 1996–97

Area	1996	1997			
		Q1	Q2	Q3	Q1–Q4
Yakutia	102.4	93.3	94.9	94.7	96.0
Jewish Ao	76.3	149.0	103.0	106.0	86.0
Tchukotka	98.1	56.4	191.0	151.0	106.0
Primorskiy Krai	91.2	94.0	96.0	95.5	97.0
Khabarovsk Krai	86.4	96.4	92.2	93.2	100.0
Amur Oblast	76.7	92.4	93.0	92.4	95.0
Kamchatka Oblast	100.2	94.7	94.6	96.9	96.0
Koryakia	67.8	168.0	118.2	84.4	100.0
Magadan Oblast	87.2	72.9	83.8	84.4	87.0
Sakhalin Oblast	83.6	90.8	88.3	92.5	95.0

Sources: Goscomstat of the Russian Federation, Ministry of Economy.
<http://www.rational.ru/economy.htm>

PROGRAMS FOR THE DEVELOPMENT OF THE RUSSIAN FAR EAST

There are various programs for restructuring and developing the economy of the Russian Far East:

- the president's Federal Program Economic and Social Development of the Russian Far East and Zabaykalye in 1996-2005 (1996), known for short as the president's "Far East" program
- the Federal Program for the Development of the Fishery Industry (1993)
- the Concept for the Economic Development of South Primorie (1992)
- the Greater Vladivostok Project (1992)
- the Long-term State Program of Economic and Social Development of the Far East to the Year 2000 (1987)
- the UNDP Tumen River Area Development Programme (TRADP)
- various regional programs to develop small businesses.

Among these plans, the main one is the president's "Far East" program (1996). For this program to succeed, it would be necessary to invest approximately \$70–80 billion. This sum is equal to the entire Russian federal budget for three years. The government has plans for investing 30% of this amount. But estimated investments were only 2% of the planned sum in 1997.

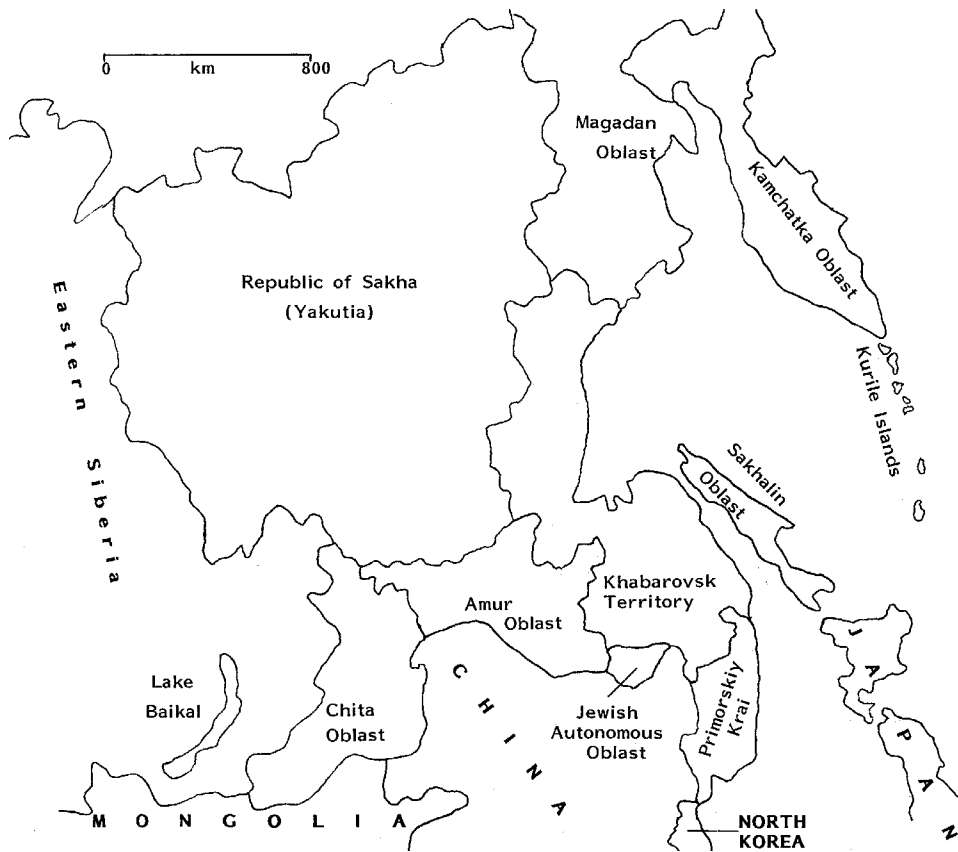


Figure 2. Administrative divisions of the Russian Far East

Russia does not have enough good management or enough capital to carry out all these programs.

To improve Russian management, the Project of Partnership Restructuring of Enterprises was created by the International Bank for Reconstruction and Development, jointly with the Russian Center for Privatization and the Pro-Invest Consortium. This project has a goal to establish and develop market management. Industrial enterprises can get loans in the range of US\$100,000–300,000 loan for management reorganization for four years. Total loan funding available for 250 enterprises is US\$85,000,000. This project is oriented toward the acquisition of modern principles of accounting, financial analysis, and business planning.

For most Russian enterprises, however, participation in this project is not realistic, because of their huge financial problems. The main conditions for participation in the program are the following:

- the status of a joint-stock company
- state ownership less than 25%
- a work force of 4,000–10,000 employees
- a transparent structure of corporate ownership and management
- tax debts less than 25% of all debts.

I worked as a local partner of the Pro-Invest Company to carry out the Project of Partnership Restructuring of Enterprises in Primorskiy Krai. We sent more than 50 application forms to different enterprises in this region. Finally, we proposed 7 enterprises, but only 2 of them were chosen by Pro-Invest for future participation in this project.

INVESTMENT RESOURCES

Investment in the RFE economy has diminished since 1992. The investment activity in a region depends on the state and regional economic policies, the financial and industrial management, and the level of savings.

The Russian Far East depends on Moscow politically, legislatively, and financially. The main tendencies of the state investment policy are the following:

- The Russian government has practically ceased to manage investment activity since 1991.
- During the first three years of the reform alone, total investments decreased to one-third, and today investment is only 30% of the 1991 level.
- Today, the share of investments in GNP is only 15%, compared with more than 40% in the Big-7 economies.

During the years of the reforms, the new banking sector had possibilities of making money from inflation. But high inflation is a factor that creates a high level of risk for long-term investment. So, the banking sector has preferred to invest money in short-term speculative activities in interbank credits, purchases and sales of state bonds (GKO, OFZs), and currency exchange. The overall volume of forward exchange obligations of Russian banks (excluding Sberbank) to nonresidents amounted to \$87.9 billion on 1 July 1998, or 86% of their aggregate capital (see 'Present State of the Russian Banking System' 1998).

The cost of a bank loan is very high for industrial enterprises. In 1993–94 interest rates exceeded 200%, and one-day loans were sometimes 900%. From 1996 to the middle of 1998, interest rates were above 50%.

During the month after the August 1997 crisis, the number of large banks that had not experienced financial problems declined from 30 to 11. And another

700 were in a difficult financial situation. To save these commercial banks would require US\$5 billion, or one-fifth of the entire state budget per year.

In the Russian Far East, 37% of the regional banks also had serious capital adequacy problems.

The potential sources of investments today are:

- investments from the local budget
- bank loans
- profit and amortization funds of enterprises
- savings of the people
- foreign investment.

Investment from the local budget is very small. Corporate finance, like the capital of the banks, has not been significant after the financial crisis and inflation. Therefore, the economy must make use of the other two sources of investment.

The people are keeping their money in US dollars, and more and more people are putting their money elsewhere. There are an estimated US\$70 billion in dollar accounts (www.news.bbc.co.uk).

This money is one of the important sources for investment in the development of the Russian economy. But there is no attractive investment climate in Russia, because we do not have a strong legislative base for it. To attract investment from the Russian people and also from foreign investors, an attractive climate is needed, and such a climate can be created only by the federal government.

The different regions of the Russian Far East have differing investment climates, depending on different factors. The ranking of the Far East regions with respect to the investment climate is shown in Table 2.

Ten percent of all foreign direct investment in Russia has been invested in the Russian Far East. The ranking and structure of these foreign investments are shown in Table 3.

A solution to this investment problem can be found in the creation of the proposed Northeast Asian Development Bank. The Russian people do not trust the banking system of Russia with their money, but they can trust an international bank. In this case, it would be necessary to change some of the laws that regulate the activities of international banks in Russia.

Table 2. Ranking of investment climate in the Russian Far East, by region

Region	Rank	Integral Index
Republic of Sakha (Yakutia)	17	1.19
Sakhalin Oblast	28	1.03
Kamchatka Oblast	30	1.02
Primorskiy Krai	34	1.00
Khabarovsk Krai	40	0.96
Magadan Oblast	49	0.90
Amur Oblast	53	0.88
Jewish Autonomous Oblast	73	0.65

Source: Predprinimatel'skii klimat v Rossii. Russian Geography for Investors and Businessmen. Moscow, 1997. 400 pages.

ECONOMIC PROSPECTS OF THE RUSSIAN FAR EAST

There is great potential for the domestic development of the Russian Far East and for its integration into the wider economy of the Asia-Pacific region, as shown in Table 4. The major exports from the Russian Far East are timber, mineral resources, and fish products. These commodities are supplied particularly to the countries of the Asia-Pacific region. The enterprises of the Russian Far East produce goods with only small added value. Therefore, the main goal in developing the regional economy is the reorientation of industrial policy, so that new, competitive industrial sectors can be developed. In this regard, we can use the experiences of postwar Japan, France, and Italy. One of the prospects for the Russian Far East is the creation of high-tech enterprises based on biotechnology.

It will also be necessary to develop international transportation and transit services as a new sector in the economy. This sector offers possibilities for the revitalization of seaports and the reconstruction of railways.

One of the main intentions for the development of the Far East is the revitalization of agriculture and the food industry, together with further development of coastal fisheries and aquaculture.

I took part in the planning of two business programs. The first was the creation of small enterprises for fish processing, in which progressive Japanese technologies would be adopted and adapted. The second was to create small aquaculture enterprises. Our analysis concluded that there are possibilities for obtaining good returns on such investments. We have planned a big training program for future entrepreneurs, with a curriculum for small businesses that

includes learning about technologies, modern legislation, accounting, and business planning.

Table 3. Investment in the Russian Far East in the first quarter of 1997

Region	Amount (thousand US\$)	Share of Total (%)
Foreign direct investment		
Primorskiy Krai	7,425	33.9
Kamchatka Oblast	5,668	25.9
Khabarovsk Krai	2,840	13.0
Magadan Oblast	2,595	11.8
Sakhalin Oblast	1,867	8.5
Republic of Sakha (Yakutia)	1,361	6.2
Jewish Autonomous Oblast	154	0.7
Total FDI	21,910	100.0
Other investment		
Magadan Oblast	15,003	66.2
Primorskiy Krai	3,500	15.4
Sakhalin Oblast	2,147	9.5
Kamchatka Oblast	1,936	8.5
Khabarovsk Krai	63	0.3
Republic of Sakha (Yakutia)	13	0.1
Total other investment	22,662	100.0

According to our understanding of how the economy should be restructured, we should begin by creating small, high-profit regional projects. This will be possible only with the use of modern foreign technology and investment. For this reason, it will be essential to develop the existing free economic zones (FEZs) and to create new zones and techno-parks. Prospective projects for new FEZs are the Kurile Islands (part of Sakhalin Oblast), which extend from the Kamchatka Peninsula southwest toward Japan. To do so, however, will require the creation of stable legislation.

Three FEZs have been established in the Russian Far East: Nakhodka (created in Primorskiy Krai in 1990), Sakhalin, and EVA (in the Jewish Autonomous Oblast). Sakhalin and EVA, however, are not real FEZs. And after eight years of experience, the results of the FEZ in Nakhodka have been more negative than positive for investors. The FEZs therefore have not yet created the right conditions for the future development of the economy, because they do not

have an attractive investment climate comparable to those in other countries of the region, especially China.

Table 4. Industrial structure of the economy of the Russian Far East

Region and Industrial Specialization	Exports
Amur Oblast	
agriculture	soybeans
electricity generation	electric power (to China)
gold mining, coal industry, forestry, construction, machine building	—
Chukotka Autonomous Oblast	
gold mining	gold
main Arctic Sea port, nuclear power station, fishing, reindeer herding	—
Jewish Autonomous Oblast	
agriculture, light industry, food industry, machine building	—
Kamchatka Oblast	
fishing	salmon, crabs, pollock
ship repair, gold mining, tourism, forestry, construction materials, mink farming, reindeer husbandry	—
Khabarovsk Krai	
forestry	timber
mining	gold, platinum, tin and copper concentrate
heavy industry, transportation, machine building, oil refineries	—
Magadan Oblast	
mining	gold, silver, tin, tungsten
fishing industry	salmon, pollock, crabs, other sea foods
mink farming	mink
coal industry, machine building, reindeer husbandry	—
Primorskiy Krai	
transportation services	transportation services
main Far-Eastern sea ports	port services
fishing industry	salmon, pollock, crabs, other

forestry	sea foods timber
Table 4 (continued)	
Region and Industrial Specialization	Exports
Primorskiy Krai (continued)	
mining	tin, fluoride, bromide, lead, zinc
coal industry, shipping companies, shipbuilding, ship repair, light manufacturing, machine building, construction materials, mink farming, agriculture	—
Sakha Republic (Yakutia)	
mining (diamonds, gold, tin)	diamonds, gold
oil and natural gas production	oil, natural gas
coal industry	coal
forestry	timber
fur production	furs
construction materials, logging, food processing	—
Sakhalin Oblast	
oil and natural gas production	oil, natural gas
fishing industry	salmon, sardines, pollock, other sea foods
forestry	timber
coal mining	—

Before new FEZs are established in Russia, the mistakes of the existing FEZs must be analyzed, and the first lesson to be learned is that the legislation cannot be changed back to what it was formerly.

One of the interest projects for developing the Russian Far East is the UNDP Tumen River Area Development Programme. The pros and cons of this program have been discussed at all conferences of the Northeast Asia Economic Forum.

Here, I would like to discuss a new idea: the establishment of a new special economic zone in the Kurile Islands.

NEW SPECIAL ECONOMIC ZONE IN THE KURILE ISLANDS

The draft of a federal law for the development of the Kurile Islands was prepared jointly by (1) the Regional Policy Ministry of the Russian Federation, (2) the

interdepartmental commission for implementing the federal program of social and economic development of the Kurile Islands, and (3) the Macroeconomic Research Institute under the Ministry of Economy of the Russian Federation. This draft, titled “A Special Economic Zone in the Kurile Islands of the Sakhalin Oblast (the Kuriles SEZ),” was published in the *Rossiyskaya gazeta* on 23 December 1998. When promulgated, this law should provide the necessary legal and economic bases for establishing and operating a new special economic zone in the Kuriles.

The draft of this law is similar to the federal law on the SEZ in Kaliningrad, and it consists of the following:

1. General provisions
2. Conditions for business activities and investments in the Kuriles SEZ
3. Banks and banking activities in the Kuriles SEZ
4. Management of the Kuriles SEZ
5. Arrangements for entering, departing from, and residing within the Kuriles SEZ
6. Social and labor relations
7. Other provisions.

The main goal in establishing the Kuriles SEZ is to create the conditions necessary for the realization of the federal government’s “Kuriles Program” on the following basis:

- attracting domestic and foreign investment
- technical modernization of enterprises and branches of the regional economy
- establishing new high-tech manufacturing facilities and increasing exports of competitive products, including highly processed fishery products
- developing small and medium-size businesses
- expanding economic cooperation and intensifying Russia’s foreign trade with APEC countries
- creating an industrial cooperation system of the Russian Federation and APEC countries, based on joint manufacturing, joint research, technology transfer, mutual investment, tourism, and so forth.

This draft includes a detailed description of the legal regulations for business activities, customs duties, currency exchange, taxation, and royalties for marine biological resources, as well as the management structure of the Kuriles SEZ. This new SEZ is basically oriented toward resources for fisheries.

On the other hand, this draft is lacking in conditions for legal protection of investments and business activities—an issue that is very significant for potential

investors. The draft of the law proposes to establish a development fund for this region from the following sources:

- payments when registering for permission to conduct business activities
- royalties for exploiting the marine biological resources of the SEZ
- assets obtained by the fund from the federal budget
- assets of enterprises and institutions involved on an agreement basis by the SEZ administration
- other sources.

The procedure for registration is not convenient from a business viewpoint, however, because it takes the form of “permission” rather than “notification.” The final decision concerning any business activity in the SEZ is in the hands of the SEZ administration. Thus the draft of the law should be changed to simplify the registration procedure and to add federal and local guaranties for domestic and foreign investors. Those guaranties could include, in particular, the resource potential of the region, state shares in large enterprises, and so forth.

The Kuriles lack the necessary economic infrastructure for development. Therefore, the first priority should be to concentrate federal and regional financial resources on developing the necessary infrastructure. Foreign investors should see and sense that there is interest on the Russian side in participating in this project and bringing it to reality.

The Kurile Islands are an important area of political interest to both Japan and the Russian Federation. Joint economic development of the islands would create a basis for an optimal solution for both countries in the future.

CONCLUSION

The results that clearly emerge from this research are as follows:

- The new economic reforms and privatization have destroyed the production base and, therefore, the industrial base of the economy. Our economy really needs huge investments, but potential investors no longer place any trust in it.
- Theoretically, most of the Russian economy is now in private hands. But from a practical viewpoint, we still face a long journey from the beginnings of the restructuring process to the stage of being internationally competitive.
- The main goal for the Russian Far East is restructuring and reorienting the economy, away from exports of natural resource and toward the development of an industrial base for value-added export products.

- This region needs the support of both the federal government and foreign investors, because it has neither enough financial resources nor management skills of its own.
- Therefore, the model for the development and management of the RFE economy has to change again. And, the solution to all these problems lies in the activation of a state policy that should be oriented toward strengthening the industrial basis of the Russian Far East.

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