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Russia in Asia—Asia in Russia:
Energy, Economics, and Regional Relations

Conference Proceedings

Edited by F. Joseph Dresen

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The Woodrow Wilson Center's Kennan Institute and Asia Program convened a conference in July 2004 to examine the evolving relationships among the countries of Northeast Asia—Russia, China, Japan, and North and South Korea—with an eye toward understanding the growing importance of energy in the region.

For much of the past century, Russia did not have a particularly close relationship with its Asian neighbors. Its focus was on Europe and the United States, and its territories in the Russian Far East were long regarded by Moscow as a source for natural resources and a military outpost. Following the fall of the Soviet Union, the region experienced steep economic and population declines. At the same time, the transformation of Russia to a market economy and the reworking of its federal system produced a host of new actors and relationships that have been reshaping Russia's presence in Asia.

The greatest factor in recent years behind Russia's growing importance to the region is the energy reserves situated in the Russian Far East and Siberia, and the demand for those reserves from Russia's Northeast Asian neighbors. As Eugene Lawson points out in his introductory remarks, the Russian Far East is adjacent to two of the world's top three energy markets and "is ideally suited to serve as a major energy supply link between Russia's oil and gas fields and China and Japan, as well as Korea, India, the countries of South East Asia, and the U.S."

Russia's neighbors have had to adapt to Russia's energy wealth—China, Japan and South Korea have all pursued new economic relationships with Russia. Yet Russia cannot maximize these new economic relationships on its own. To realize the potential of its energy projects in the region, Russia must rely on investment and technology from foreign multinationals. Whether it will successfully do so is in some doubt, according to several panelists. The climate and terrain where the resources are situated are harsh and unforgiving. The cost of developing the various proposed gas and oil pipelines runs into the billions and is constantly increasing. More daunting than the physical climate is the investment climate, especially in recent years.

Nevertheless, Russia is enhancing its status as a major player in Northeast Asia. Russia has a seat at the table in the multilateral talks on the nuclear issue in North Korea, and has the potential to play a vital role in finding a resolution. China and Japan are vying with each other for access to Russian energy reserves, allowing Russia to push for deals that serve its geopolitical, as well as economic, interests. Russia must also work to balance economic development with preserving one of the world's most diverse and important ecological areas.

Yet, as became clear in several of the presentations during the conference, a number of challenges remain. "Soft" security issues such as corruption, cross-border criminal activity, and population movements hinder legal trade in non-energy sectors and Russia's closer integration in the regional economy.

The geopolitical landscape of Northeast Asia is changing, and this conference was an attempt to assess the current situation to inform Russia-watchers in Washington of the complex dynamics underway in Asiatic Russia, the implications for Russia's geostrategic role in the region, and the economic and political ramifications for China, Japan, and North and South Korea.

The conference was conceived and planned with the assistance of Mike Bradshaw of the University of Leicester, and I am pleased to take this opportunity to thank him for his efforts. My colleagues in the Asia Program provided much needed assistance and support in organizing and running the conference. I also would like to acknowledge the Woodrow Wilson Center for providing the federal conference funds that made the event possible.

—*F. Joseph Dresen*

Introductory Speaker

EUGENE LAWSON Given the resources of the Russian Far East and Sakhalin, the region gives the Russian Federation the potential to shape economic relationships in Asia, as well as provide a powerful source of leverage with its strategic partners. Situated on the borders of two of the world's top three energy markets, the Far East is ideally suited to serve as a major energy supply link between Russia's oil and gas fields and China and Japan, as well as Korea, India, the countries of South East Asia, and the U.S. natural resources are the main driver—not the only one, but it is obviously the main principle driver today of relations between Russia's Far East and its Asian neighbors, with the focus on oil and gas.

Russia is one of the only countries in the world whose oil and gas reserves estimates—proven and probable—continue to increase. And much of these resources are located in East Siberia and the Far East. China and Japan are two of the world's largest energy importers, and both are eager to gain access to Russian supplies. Their needs, like those of the United States, are insatiable. They need crude. Aside from their close proximity to both countries, Russia's energy resources represent the chance to diversify supplies and decrease reliance on the Persian Gulf and elsewhere, which both China and Japan dearly desire. But this past year has witnessed a growing competition between China and Japan for access to East Siberian oil and gas, and one that threatens to complicate Russia's strategic relationships.

This energy competition began to intensify with the competing pipeline proposals that have emerged in the last several years. This is something that Paul Rodzianko knows about, and will be addressed in Panel 2. The Russian government and YUKOS Oil Company negotiated an agreement to build a pipeline from the Angarsk facilities in East Siberia to the refineries in Daqing, China. The pipeline was to be funded in part by YUKOS and was to provide over 30 million tons of oil per year to China after the year 2005. However, disagreement over the ownership structure of the pipeline delayed the feasibility study and ultimately construction. In the interim, Transneft, the Russian state-owned

pipeline company, and Rosneft, the Russian state-owned oil company, produced a plan to build a pipeline to the Far East port of Nakhodka in order to ship oil to Japan, China, and also possibly to other Asian countries and the United States. The Japanese government was quick to support its adoption, and has subsequently agreed to fund the construction of the pipeline, estimated at over \$12 billion dollars and growing. It seems like every time I see a new feasibility study about what it would cost to build this pipeline, the costs keep going up, and up, and up. The Japanese were originally in for about \$4 or \$5 billion dollars, and they have been a little bit quiet recently as the costs keep increasing.

Tokyo has also recently pledged additional funds for the development of East Siberian oil fields. I think it is safe to say that the threat to Transneft's pipeline monopoly posed by YUKOS' proposed Daqing pipeline plan was at least part of the reason for the Kremlin's decision to support the Nakhodka pipeline. This line, while it gives the Russians the ability to export to more than one consumer, is much more costly than Daqing and is less viable economically. A firm decision has clearly not been made. It is very much up in the air right now as the Russians debate the nature, the shape of their energy policy as to which plan Russia will ultimately pursue, but the recent pronouncements would favor the Nakhodka line.

Now, in a move to lessen the blow to China—because do not forget that the Russian government did originally sign on to the agreement with YUKOS to build the Daqing line—Mr. Putin announced while actually in China that the Russian railways monopoly has agreed to increase rail shipments of oil to China from 60,000 barrels of oil a day to 120,000 barrels of oil a day. Now it is very expensive to do that, but I might add here in passing that it is also not a bad way to put some money into the Russian railroad system, which certainly does need it. So it may be a way to placate China and also to put some money into the Russian railroads. The Russian government is also currently discussing a proposal for a gas pipeline from the Kovykta fields to China and on to South Korea. And I will not go into detail on that; I will leave that to Panel 2.

Russia is one of the only countries in the world whose oil and gas reserves estimates—proven and probable—continue to increase.

Due to the need for energy imports in China and Japan, it is very clear Russia has been able to bargain from a position of strength with its trading partners. Japan has agreed to fund the construction of a pipeline—they said they would invest \$4 or \$5 billion dollars—in the development of the East Siberian oil resources.

To this point, Russia has succeeded in getting concessions from Tokyo while at the same time not angering the Chinese. This is quite a diplomatic feat. Increased oil exports via rail to China will ease the pain of losing the Daqing pipeline construction somewhat. The impact that these decisions will have on Sino-Russian relations remains to be seen. To this point, the Chinese have been patient in their public pronouncements; in fact, even going so far as to say that the choice of the Nakhodka pipeline is an “understandable one.” It seems that Beijing is holding out the hope for renewed energy partnerships in either the gas or the oil market. Russia’s reliance on Japan to fund the Nakhodka pipeline could have serious diplomatic consequences. There is some leverage that you might give the Japanese if Tokyo decides that the time is right to reassert demands for talks over the status of the Northern Islands in exchange for this investment. Obviously, Russia is well aware of this duality.

Beyond the economic considerations, Russia has a strategic interest in creating close energy ties with China. Without long-term guarantees of supply from Russian oil and gas fields, China is increasingly turning to Kazakhstan and a proposal to construct a pipeline across Xinjiang Province and Western China. Russia continues to view former Soviet countries as a very special area of interest in its strategic relationships, and it typically guards against encroachments from outside powers that could decrease its influence in the region. However, Beijing is anxious to insure its own energy security through diversified supplies, and is willing to undergo the expense of construction of a pipeline from Kazakhstan through the very rough terrain of its western provinces there—Xinjiang is not a piece of cake to put a piece of pipeline through. China is on the move everywhere in the world to find crude. It is paying, sometimes, exorbitant prices here or there in various world markets to keep this economic development going.

The Kremlin must balance these considerations with a reality that a dedicated pipeline to

Daqing would lock Russia into a single consumer. Plans to construct a lateral line from the Nakhodka pipeline that will supply Daqing have met with criticism. Many observers here who know a lot more about the oil situation than I do doubt that there is sufficient production capacity that now exists in the East Siberian fields to fully utilize two pipelines.

Although they have taken the focus of late, relations between the Russian Far East and Asia do not merely rest on energy relationships. Both Russia and China are taking steps to utilize their 4,500-mile shared border to economic benefit. An agreement signed just last month will create a free trade zone at Vladivostok at an estimated cost of \$1 billion dollars. The free trade zone is expected to open within 10 years, and it is hoped that the zone will provide a platform for trade and investment, tourism, and the development of high technology industries. There is another free trade zone that is already under construction in China’s Heilongjiang Province.

Timber is another area in which China’s growing demand has forced it to look to the Russian Far East. Beijing has already begun to import large amounts of timber from the Russian Far East and favorable tariff and tax measures have been established. Tax regimes have been established to encourage this trade. A Sino-Russian timber trade market was established in China to further enhance this economic relationship.

Despite the growing economic ties, Russia continues to be concerned with border issues in its relations with China. Common borders of 4,500 miles do not necessarily make good neighbors, as we know from Russo-Chinese history. While the Far East is sparsely populated and resource-rich, the Chinese regions that border it have about 200 million people. Russia also faces a demographic challenge in which its population has been shrinking. In fact, there are some people here in Washington at Brookings that say that is the way to go—the population should be shrinking in the Russian Far East. Yet China’s population continues to grow. Regional governments and the Kremlin must balance economic and trade considerations with the fear of excessive Chinese immigration that could threaten to turn the Far East into an economic satellite of Beijing.

China is the fastest growing economy in Asia, one of the fastest in the world, with a voracious

appetite for energy and other resources. Russia's ability to supply these resources and desire to exert influence over its trading partners must be tempered with the fears of becoming solely a raw materials exporter, and with a strong desire to avoid being locked into a single export market.

Japan could be the source of investment that Russia's energy infrastructure needs in the Far East, but becoming too close to Tokyo could have serious repercussions on Russia's ties to China, and could result in Japan increasing pressure for settlement of the northern territories issue.

While the Russian Far East holds the potential to serve as a lever to exert influence in Russia's bilateral relations in Asia, Moscow must continue with great caution and skill. It is clear though that the resources of the region and the needs of China, Japan, and the two Koreas create enormous potential for economic partnerships if the parties can get the politics right. Thank you all very much.

Discussion

Q. *There is one elephant in the room that you pointed out at the beginning and then did not really mention—the United States. When you say the politics are important, clearly we have some ability to influence the politics of the regions. How do you see the Americans and the Europeans fitting into the dynamics you just described?*

EUGENE LAWSON Not easily and not in a powerful sense, to be honest. I do not think, in these matters in the Russian Far East, that the United States has all that much leverage. We are working on pipeline proposals to Murmansk, we are working on other energy matters in the Caspian, and I do not think we feel like we have a dog in that fight. I think there are too many sensitivities here already for the United States to play a constructive role. And I think the same thing is true of the EU. Frankly, I think Russia would listen more to the EU than the United States at this point in time. And there is one basic reason why they would, and that is that the commercial relationship with the EU has just taken off with Russia in the last four years. In the last four years, U.S.–Russian trade has been flat, right at \$10 billion dollars. It is not very impressive. It makes Russia about our 31st or 32nd largest trading partner.

Meanwhile, in the same period of time, Russian–EU trade has grown to \$110 billion dollars, 11 times now what it is with the United States. That is economic leverage. That is power. And there is no question in my mind that Russia is shifting her attention to commercial matters in many respects from the United States to the EU. So if anybody is going to have any leverage over there, it is probably going to be the EU.

Q. *I formerly worked at the Department of Energy, which has several agreements with its counterparts in Russia. I asked Secretary [Bill] Richardson to express his opinion about the value of these agreements. He seemed somewhat skeptical, but more sanguine about cooperation in the private sector. Could you please give your opinion about the respective roles and merits of the government on the one hand, and industry and commerce on the other?*

EUGENE LAWSON Well, that is a very good question. I certainly respect Secretary Richardson, with whom the Council had a good relationship. He was very, very cordial and gracious to the U.S.–Russia Business Council, and a very shrewd observer and a good Secretary of Energy. I would say right now that the energy dialogue that exists between the United States and Russia has slowed to a trickle.

We really have not made much progress for quite some time. Two years ago, of course we had the Houston Energy Summit, which I think sparked a great deal of optimism and enthusiasm. A year later, last September in St. Petersburg, we had the second meeting of the Russian–U.S. Energy Summit. The word at that time on everybody's lips was "Murmansk, Murmansk, Murmansk." We thought everybody was on board, the Russian government, the Russian private sector that had formed a consortium to build a private pipeline to Murmansk, and certainly the Americans. The U.S. private sector thought this was just a win-win for everybody. With a buy-in by the Russian government, it was going to happen. The economics were right, the politics were right, everything was right. And today, a little less than a year later, there is no one talking about Murmansk, because there is nothing going on there right now.

That is too bad, because we have had such hopes in the past. I guess it was the famous U.S. philosopher, Gypsy Rose Lee, who said that,

While the Russian Far East holds the potential to serve as a lever to exert influence in Russia's bilateral relations in Asia, Moscow must continue with great caution and skill.

“All life is a matter of managing your expectations.” We had great expectations in the oil patch in this country here for a really profitable, close, cordial working relationship. We were totally engaged with the Russians in the energy sector. In fact, when Bob Strauss and I first started this council in 1993, the first committee was the Energy Committee, because we thought that was a natural fit between the two countries, you would get such synergy out of good and close cooperation there that would spin-off and have a ripple effect throughout other industries. Frankly, we spent a whole decade chasing the mirage of production sharing agreements (PSAs).

There are some today who say, “Well I told you all along they were not going to be there.” It was always possible that we were not going to get PSAs with companies like YUKOS, which absolutely told its Duma supporters to vote against PSAs, and other people in the Russian government who did not want to have them. We spent ten years working hard to get production sharing agreements in place and we never got them in place. The thing that really killed them in the end was the massive investment by BP in Tyumen oil. It meant that BP had made the evaluation that, yes, we can play by Russia’s tax regime and laws.

It is a long, winding answer to a good question. I fear right now—without some sort of jumpstart, which I do not see on the horizon, but I am always ready to be surprised and hopeful about being surprised—that there is not much going on. I have a feeling that the Russian government does not wish to have U.S. equity participation in Russian companies at this time. There is no question in my mind that with the new move toward economic nationalism in Russia, with the rise of statism, and with the state clearly taking a much more prominent role in the administration, regulation, and ownership of natural resources as it has in the past (and just in the last few months we have seen evidence of this), that U.S. companies are no longer really talking to Russian oil companies. They are talking to the Russian government. The Russian oil companies

are not talking to us. They are all scared because they do not know where Mr. Putin is really going just now. As a result, U.S. companies are going in to see the government and talking to the government, and they are saying to the Russian government, “We would like to play in this market, tell us how to do it.” We are still, frankly, looking for an answer in that regard.

Q. I am curious in terms of regional integration—what about the cultural aspect? The languages, their cultures—do they become barriers to developing integration among those Far Eastern countries, Russia particularly among the Northeastern Asian countries? I am curious about the language problems or cultural issues, besides investment, and security, and so forth.

EUGENE LAWSON That is a very good question. I alluded briefly to the fact that a common border between two countries does not necessarily make good friends, as you see throughout Russian-Chinese history. And it is a proven fact that after they dropped their imperial regimes, both countries still did not get along. That is both political and cultural, to be sure.

I think there is a fear and suspicion on the part of the Chinese toward Russians, and the Russian have the same kind of fear and suspicion of the Chinese. I think that the Russians have a fear of the Japanese, too, stemming from the war in 1905, and then of course from 1940 when Japan was thinking actually about going north before it went south at the outbreak of World War II. So there are lots of political suspicions, and it is all exacerbated and fueled by differences in culture, too.

Cultural differences are the hardest things to change. You can change politics, you can change social things, you can change the economics, but the more difficult things to change, in the end, are the cultural. They are the slowest to change. You have in these three civilizations, long, rich cultural histories, and that increases the sense of not just xenophobia, but of identity. I think it makes it that much harder to be flexible sometimes in their diplomatic positions. Thank you for the questions.

ALEXANDER FEDOROVSKY Thank you very much, Mr. Chairman. It is a great honor for me to participate in this conference, and I appreciate the opportunity to make a presentation here. I would like to inform the audience about my point of view on economic trends in the Russian Far East and Russia's economic policy toward the Pacific area.

It is hardly possible to describe briefly economic developments in the Russian Far East as well as economic relations between the Russian Far East and its neighboring countries. So I will try to focus on some main trends in the Russian Far East, and I will try to describe the framework of Russia's present economic policy towards Northeast Asia.

From 1991 to 1998, industrial output in the Russian Far East declined by 60 percent, while in Russia, by 50 percent. In Khabarovsk krai and Amur oblast, the decline was about 70 percent. These declines came during the period of reforms, because this region was a highly militarized area where a lot of the military industrial complex was situated. In general, before economic reforms started, 75 percent of Russian Far East output had been consumed in other parts of Russia and in the former Soviet Republics, about 20 percent was consumed inside the region, and about 5 percent went for export. The reforms changed this distribution dramatically. About 10 percent of output is now consumed in other parts of Russia, 72 percent is consumed within the region itself, and about 18 percent is now exported. During this difficult time, a lot of new private enterprises and institutions learned how to survive. So this may be one of the positive results of these reforms. The economic structure in this area began to be more adequate to the real market situation at home and abroad.

Following the financial crisis and default in 1998, one can see new economic trends underway in the Russian Far East: A regular increase of GDP, industrial production, and other key economic indicators of economic development in the Russian Far East that are the same or even higher than average in Russia. But economic development in the Russian Far East is based mainly on the development of resource industries. As a result, the industrial structure of the region is now more lopsided than previously.

Metallurgy, extractive industry, energy, and electric power industry prevail in the economic structure, while the share of manufacturing is only about 10 percent in the region. Between the individual regions of the Russian Far East, there are quite marked disparities based on resources, economic structure, political and economic situation, and local governmental behavior.

During the reforms of the last decade, the Russian Far East lost a large percentage of its population. But the population has decreased primarily in northern area of Russian Far East with very difficult climate conditions and a very high cost of living. We can thus talk about the collapse of the Stalinist Gulag-type of development of the northern part of the Russian Far East. At the same time, the decrease of population along the south belt area in Amur oblast, Primorsky krai, and Khabarovsk krai (which, in many respects looked like the most promising area of the Russian Far East), has been notably less than for the Russian Far East in general. Demographic problems are closely connected to quality of life issues. In most of the Russian Far East regions, the percentage of those who live below the poverty line is much bigger than in Russia in general. Unemployment was also higher on average than in Russia, especially in northern areas.

Meanwhile, at the beginning of this decade there were some positive trends in the social situation. The rate of people living below the poverty line has decreased significantly during the last five years. In Primorsky krai, this figure decreased from about 50 percent to 30–33 percent. This was evidence, of course, of economic growth of 7–8 percent annually, but this is also evidence of a more civilized economy, because more people now declare their income.

Although the share of Russian Far East in Russia's foreign trade remains insignificant (about 4 percent of total trade) the Russian Far East's share in bilateral trade with Northeast Asia countries is larger and is fluctuating at about 30 percent in exports and about 60 percent in imports. But it is necessary to take into account the unofficial trade: so-called "shuttle traders," which are primarily importers of consumer goods from China and Korea; and so-called "sea trades," when Russian traders sell fish and buy fuel for their fishing fleets without actually visit-

According to Mr. Putin, membership in APEC is very important as preparation for Russia to join the WTO.

ing the Northeast Asian countries. In general, unofficial trade is very significant and estimated between \$8 and \$10 billion annually.

Foreign direct investment (FDI) in the Russian Far East was insignificant during the 1990s. But during the last several years, the situation has begun to change. The scale of investments reached \$1.5 billion last year. As a result, the Russian Far East has begun to play a prominent role in attracting of foreign investment to Russia. The region's share of FDI increased from 7 percent to 18 percent in the country. Of course, these investments are primarily accumulating in the Sakhalin oblast in the Sakhalin-1 and Sakhalin-2 oil and gas projects. But the growing investment in this area has a positive effect on the economy of the Russian Far East in general, and especially in the south belt, because manufacturing enterprises are more actively involved in the realization of these investment projects.

Under the Putin administration, the Federal government began to play a more active role in the development of the Far East economic area. It is necessary to mention that the Federal program of economic development of this area was initiated two years ago and this program is developing rather successfully. The core of the policy of the Federal government in the Far East area is the development and modernization of regional infrastructure. Reconstruction of the Trans-Siberian railway has been realized successfully. The Amur-Baikal Railway has been constructed at last. The road between Chita and Khabarovsk is being constructed with financial support from the European Bank, and the road will be finished in 2007. But even now, it is possible for the first time in Russian history to go by car far from Moscow to Vladivostok.

Information and communication systems are developing very quickly. Construction on the first part of Bureya power station has begun to have a positive effect on the energy situation in the Russian Far East. And a gas pipeline from Sakhalin to Khabarovsk and Vladivostok is under construction, according to the Federal program.

It is necessary to say that during the last five years, federal government and regional authorities have reached a compromise on economic policy and they successfully divided their power bases on the new Federal laws on natural resources, etc. But the construction of strategic oil and gas pipelines from East Siberia to the

Russian Far East into neighboring East Asian countries will play the most important role in this program.

These projects have economic, social, and political aspects. The great promise of the developing oil and gas industry, as well as the energy industry, in the Russian Far East has the potential to improve housing conditions radically, to expand the resource base for the refining and chemical industries, to improve the employment situation and income distribution, and, lastly, to expand the export base and economic relations with neighbor countries.

I would like to briefly inform you about the modern policy towards the Pacific area. Russia has become a member of APEC (Asia-Pacific Economic Cooperation) for reasons that are other than economic and mainly political. It seems that for Russia's leaders it was strange that Russia was not a member of the organization to which three major powers—the United States, China, and Japan—belong. The problem for Russia as a member of APEC has mainly arisen from the fact that it has not worked out a comprehensive and consistent policy on interaction with Asia-Pacific region in general.

There were a number of difficulties Russia encountered in joining APEC: Economic and social instability in Russia, economic decline in Russian Far East, lack of attention from the federal government to problems in the Russian Far East, the regional rivalry and a lack of cooperation among the regions of the Russian Far East, and a lack of interest among the larger Russian businesses in Pacific markets. In addition, Russia entered APEC at the time of the Asian financial crisis in 1998. Since that time, sub-regional and bilateral cooperation has begun to play an important role, especially among the Northeast Asian countries.

Several times President Putin has stressed the necessity to develop broad-scale relations between Russia and APEC. According to Mr. Putin, membership in APEC is very important as preparation for Russia to join the WTO. According to Mr. Putin, Russia joined APEC taking into account prospects for liberalizing its economy. Russia's membership in APEC means Russian transformation to a liberal and open economy is a declared goal. Besides, APEC presents Russia the only institution where it can interact on economic issues with her East Asian neighbors.

Through participating in APEC, Russia now has a chance to gain experience in developing human resources on improving the management of small and medium business. It is also important that APEC has a network of facilities to provide Russian government officials, regional officials, and private business with valuable information about various aspects of social economic development and cultural diversity in Asia-Pacific countries. Without this information and knowledge, Russia's deep integration in the region would be difficult.

During only the last two years, a number of symposia, seminars, meetings, and working groups have been organized in different cities in Russia, mainly in the Russian Far East. Recent trends in the regional economy stimulate closer economic cooperation in Northeast Asia. President Putin constantly stresses the importance of active involvement in the regional process. Nevertheless, it will take some time for the Russian leadership to move from strategically proper words about the importance for Russia to be engaged in the Northeast Asia economy to proper deeds. This problem cannot be solved overnight, but the government has to determine Russia's priorities in this region. And one of those priorities is cooperation in the energy industry, as mentioned today.

A great test for the Putin administration will be the decision to construct a pipeline from Siberia to the Russian Far East, and then to the Northeast Asian countries. I believe that it will be the most important decision for President Putin during his second term. Nevertheless, I believe that the decision will be in Nakhodka's favor. It means that Russia will declare that China is Russia's strategic economic partner, but that Russia will try its best to diversify energy exports in the area, and will develop strategic economic relations with Japan, with Korea, and with the United States.

Putin's recent policy in the Far East means increasing the role of the state. I think it was quite natural, because previously private business tried to do this job alone. Of course, it is a danger when government men dominate the economic sphere. I think that the prospects of economic development for the Russian Far East, at home and abroad, will depend on the question how the government and business will cooperate at home and abroad. Thank you very much.

ROBERT ORTTUNG Thank you. I want to change gears a little bit and focus on more political issues. But my talk follows very closely with the previous talk in that what I want to look at is regional politics and the competition for influence. Most specifically, what I want to do is look at the increasing connections between the state, business, and the criminal world; and I want focus in particular on the recent elections in Primorsky krai for the mayor of Vladivostok. Obviously, this is not entirely representative of the Russian Far East, but I think it is increasingly important to look at it, and I think that the elections in Vladivostok are increasingly symptomatic of the situation in Russia as a whole. What I want to do in my talk is examine those elections in a little more detail and ask the questions and try to address why did this happen, how did this happen, and what do these developments tell us about the competition for influence in the whole region of the Russian Far East.

On Sunday, just a few days ago, the voters in Vladivostok elected Vladimir Nikolayev as their mayor. He is an extremely well known crime figure in that region. Where I work, at the Transnational Crime and Corruption Center at American University here in Washington, D.C., we have a partner research center in Vladivostok, which is headed up by Vitaly Nomokonov, who is a well-known criminologist in Vladivostok. In 1998, six years ago, he published a book describing the local organized crime scene in the city. That book directly describes Nikolayev as a member of the now-deceased Sergei Baulo organized crime group. And Nikolayev, at that time and today, was known among his colleagues in the criminal world as Winnie the Pooh. That was sort of a strange nickname, and one that would suggest that he is a rather soft, fluffy character. But in fact, at the time, he was known as a *bezpridelnik*, someone who, even in the criminal world, did not recognize any authorities, whether legal authorities or the traditional authorities that were usually present even among crime figures. And the book, which is now used as a textbook for all criminologists and lawyers who are trained in Vladivostok, describes Nikolayev as someone who used flamethrowers and other heavy weapons when resolving conflicts with other members of the criminal world. Unfortunately, we have been dealing with this issue quite directly because Nikolayev's lawyers

If you look at the members of organized crime groups, and think about what kind of role they can play in politics, you see that such members of crime groups bring a lot of assets to the political game.

have threatened to sue our researcher in Vladivostok for publishing this kind of information in his book unless he retracts it. But so far, Nomokonov has not retracted his previous work, and luckily, Nikolayev has not filed suit against him either. So that is where the situation stands.

Nikolayev, at the end of the 1990s, was sentenced to three and a half years in prison for beating one official and threatening to kill a second official. He served for one year and three months of that sentence before he was amnestied. He has been quite successful in Vladivostok. He is quite wealthy, owns a fishing firm and a meat factory, and, what is probably even more important, he used that money to buy a leadership position in the local branch of the pro-Kremlin United Russia Party, which is, of course, the party that now controls the majority in the Duma and is closely affiliated with Vladimir Putin. Now he is the mayor and he is taking charge of what is going on. I wanted to try to explain how someone like this gains a position of power, and what are the consequences of this increasing connection between business, politics, and the criminal world.

I think the first part of the answer to explain what is going on there is that there is a very strong criminal element in the Russian Far Eastern economy, and in particular in Vladivostok. That is particularly evident in the field of automobiles. Most automobiles are brought in from Japan by members of the navy and then sold, usually illegally, on the black market. It is also evident in the fishing industry. In Russia, most fish are caught illegally and sold offshore, bringing the people who control the process huge amounts of money. Finally, Vladivostok and many of the cities in the Russian Far East are port cities and are transshipment points for logs, many of which are cut down illegally, and Russian metals, both of which are exported to Asia. There is a strong criminal element in the local economy.

If you look at the members of organized crime groups, and think about what kind of role they can play in politics, you see that such members of crime groups bring a lot of assets to the political game. First of all, they have strong networks. Through their activities, they have lots of people throughout the region who they can call on to support them. They have the ability to gather large amounts of money and pay bribes, and no

compunction about paying bribes. Obviously, this is a very useful resource in the political game. They also have an ability and willingness to use force and intimidation at key moments. I think Nikolayev would be a good example of the kind of violent entrepreneurs that Vadim Volkov describes in his work about St. Petersburg. Also, the criminals are focused purely on their self-interest, and they have a clear understanding of what the population wants. This makes it very easy for them to present messages to the local voters that would make them attractive.

Part of the story of Nikolayev's rise must be found in the local situation. But a second part of the story really involves the Kremlin's efforts over the last decade to intervene in regional politics in the Russian Far East. What I want to do is tie the election that happened just this week—the mayoral election in Vladivostok—to the gubernatorial election that took place in Primorsky krai in 2001.

If you look back over the 1990s in Primorsky krai, the main story then was the battle between the Kremlin and former Governor Yevgenii Nazdratenko. And at that time, Nazdratenko controlled the region in close alliance with local business interests. In the 1990s, Nazdratenko and the local business groups had basically formed a closed region and worked very hard to keep all outside business groups and outside influences from the region. This provoked a lot of conflict with the Yeltsin administration, which was waging a campaign to remove him from office through most of the second part of the 1990s. But Yeltsin never succeeded in getting Nazdratenko out.

About one year after taking office, Putin made an infamous phone call to Nazdratenko in which he offered Nazdratenko a very lucrative job in Moscow as the head of the state fishing committee, and perhaps threatened him at the same time with prosecution if he did not leave Primorsky krai. Nazdratenko finally resigned, and so it seemed like the Kremlin was going to have its way in the region. And Putin, through his Presidential Envoy to the Russian Far East, Konstantin Pulikovskiy, tried to elect a loyal supporter as a new governor. That effort failed, and what happened instead was the voters, in a surprise election, chose Sergei Darkin, who, according to our colleagues, is also very closely connected to organized crime groups in the region.

What we see today is a logical result of that election in 2001. The Kremlin intervened in a very clumsy way, provoking a popular reaction against it. It is not only that there is a criminal element in Vladivostok, but it is also the nature of the Kremlin intervention that explains the result.

The third piece of the puzzle in explaining what is going on there has to be the rise of the *siloviki* in Russia. And by the “*siloviki*,” of course, I mean the people from the KGB, the Federal Security Service, the police, and the military that now hold highly important political positions in the Russian political system. In Russia, as in many countries, there are very close connections between the police and organized crime groups.

As the work of Olga Kryshtanovskaya has made clear to us, Putin has filled the elite with people who have come out of these security agencies, military, and police. According to her, at least 25 percent of the current elite in Russia is basically affiliated with the *siloviki* in one way or another. I think that the rise of these *siloviki* in Russia as a whole and the rise of the criminal/businessman/politician in the Russian Far East are really two sides of the same coin. The trends that we see in Vladivostok are perhaps the most extreme representation of the broader trends that are going on throughout the rest of the country.

There is pretty clear evidence that the federal authorities were actively involved in bringing Nikolayev to power. For example, Pulikovskiy, Putin’s Presidential Envoy to the Russian Far East, switched from saying that the main goal of the Federal government was to block the rise of criminals to political power to saying that he would work with whoever was elected, which was a very unobvious signal that they would back Nikolayev. Another example: in the first round of the election, Nikolayev was the first place finisher, and the second place finisher was the former Mayor Viktor Cherepkov. Right after the first round was completed, Cherepkov was injured when a bomb went off outside of his headquarters, and then a few days later the Electoral Commission disqualified him from the race. Following that, the third and the fourth place candidates also dropped out of the race. Ultimately, Nikolayev competed only against the fifth place finisher in the runoff. The head of the Ministry of Internal Affairs (MVD) in the

Russian Far East, Anatoly Zvonarev, tried to cast doubt on whether Cherepkov had actually been attacked. That is a clear signal that the Federal government was using its influence to try and discredit any potential opposition to Nikolayev, and, as a result, seemed to be working in his favor.

The reason is that for the *siloviki* that are part of the ruling elite under Putin, it is much easier for them to control somebody like Darkin or Nikolayev—people who have clear and demonstrable ties to the criminal world—than it would be for them to control somebody like Cherepkov. I would argue that perhaps this is a new meaning of the term “managed democracy,” that if you have an increasing police state it is much easier for them to manage people on whom they have compromising information. In this sense, the real players in Vladivostok, in terms of the political and economic elite, were clearly Darkin and his crowd. They seem to be connected to Nikolayev, although it is clearly not a monolithic group.

The former governor, Nazdratenko, and the now former mayor of Vladivostok seem to be a second clan that was competing for power—though Darkin and Nikolayev clearly seem to be in the ascendancy. People like Cherepkov, who you could arguably say represent a kind of democratic alternative, although not a perfect one by any means, were completely outside of the system. As far as the federal government was concerned, it was much better to have somebody they can control than somebody they cannot control.

Here I want to bring in the role of big business. While the Kremlin did not succeed with their candidate in 2001 with the gubernatorial elections and the rise of Darkin, it did actually get a governor that was much more malleable than Nazdratenko was—somebody who was much more willing to listen to Kremlin orders than the previous governor. Secondly, the election of Darkin advanced a second Kremlin goal, something that Putin had put at the top of his agenda in terms of reshaping Russia’s federal system, which was opening up regional economies that previously had been closed to larger Russian companies.

When Darkin came to power in 2001, he opened the economy in the Russian Far East to big Russian business. These firms quickly came

in and pushed aside many of the local business interests that had been so strong under Nazdratenko, particularly in the areas of raw materials, foreign trade, and retail trade. Just to take one example, Russian metal companies had a very strong interest in the Russian Far East because just at that period the United States had restricted cheap metal imports to the United States. Russian metal companies had lost the market that they developed in the United States, and so shifted their attention to the Asian countries. Since Russian companies are keenly interested in protecting their entire line of production, the Russian metal companies started buying up ports in the Russian Far East so that they could control the whole process of producing their metal and then shipping it abroad. Increasingly in the Russian Far East, the local business interests are being pushed aside and big Russian companies are coming in.

A fourth issue needs to be examined beyond the local criminal world and the federal government's political and economic intervention into the Russian Far East, and that is the question of why Russian voters are backing those kinds of candidates. I think what we are seeing in Vladivostok is a continuation of the trend in the March presidential elections, where people freely chose to elect a non-democratic candidate as president of the country. They used democratic methods to put in place non-democratic policies. The same thing seems to have happened here. And while the elections were by no means free and fair, you cannot simply dismiss the results as a falsification, because there was an opportunity, if people did not want Nikolayev to be there, to vote "against all." That choice did not win—instead, 52 percent of the people voted in favor of Nikolayev. This is not the only case where this has happened. Several years ago in Nizhny-Novgorod, a very progressive city in European Russia, voters elected a mayor who had clear criminal ties.

While many residents of Vladivostok are in a state of shock that this could happen in their hometown, it is something that needs to be explained and understood. Why would people use a democratic method to elect a non-democratic candidate? And part of the answer is that the old politicians, like Yury Kopylov, the incumbent mayor, had not done a very good job in managing the city. Many apartments in

Vladivostok, despite the enormous wealth that we have been discussing in terms of energy resources, simply did not have water. Thus, part of the explanation is that people like Nikolayev had been able to use very effectively the resources they accumulated in the 1990s, in particular the money and the support of the governor, to win office. In effect, the criminals have been able to mobilize democratic forces much better than other parts of the population.

To conclude, what does this election tell us about the political system in Vladivostok and the larger implications for Russia? What we are seeing very clearly is a merger of criminal, business, and political power in the country. One way, a sort of positive way, you can look at it is that it is a very quickly moving process in which criminal groups are trying to legitimate their ill-gotten gains through the political system. I saw a recent article in the local newspaper *Zolotoi rog* that noted: "the previously young and hungry businessmen—what they call wolves—have transformed themselves into respectable members of society." It is interesting that in Vladivostok, the businessmen who got their money in the 1990s have chosen to launder this money and to make it respectable through the political process. They have not used that money to invest in local factories and create new jobs. It is very interesting to compare them, for example, in Vladivostok, with other businessmen. I was in Angarsk last week where the oil refinery is that we have been talking about that would be exporting oil to China or Japan. I was talking to the people at YUKOS, and they were arguing that however they got the money in the 1990s, what they have done with it since has been *very* productive because they are providing hundreds and thousands of jobs to all sorts of people in Angarsk, and they are keeping the economy afloat. What we see here is something a little bit different in Vladivostok than what you see in Irkutsk. There is the same process of taking the money that was made in the 1990s and trying to make it legitimate, but through two different ways—one political, and one economic and social, providing jobs.

You could look at the positive aspects of this, that the criminal money is now becoming legitimate and is functioning in the regular economy. The negative side is that the direct capture of the political system through the ballot box by a criminal business elite is extremely dangerous.

The most apparent danger is that the new political elite will use the methods that they developed in the criminal sphere as part of the political process. That will really weaken the quality of democracy in Russia.

JOSH NEWELL We are going to shift yet again, this time to environmental issues. A number of the things that I am going to talk about are related to corruption and the control by criminal interests over some of the major resource sectors in the Russian Far East. So, Bob's talk is definitely relevant to mine.

For those of you that do not know me, I have been working in the Russian Far East about ten years for a number of different organizations on a wide variety of issues ranging from the Sakhalin gas projects to the timber sector. The latter included work on illegal logging and documenting corruption and the involvement of organized crime in that industry. In the mid-1990s I did an assessment of the protected area system in the Russian Far East, looking specifically at gaps in that system in terms of conserving biological diversity and providing recommendations for how to expand the protected area system. And finally, I have been involved in a lot of "alternative development schemes," such as ecotourism initiatives, alternative energy projects (particularly in Primorsky krai), and non-timber forest product development.

For the last six years, I have been very deeply involved in a major research and book project, and I am very relieved to announce that it was published in March 2004. The title is *The Russian Far East Reference Guide for Conservation and Development*. Essentially, we like to think of it as a one-stop resource for data on the Russian Far East. Of course, the book includes basic industrial data, ecological data, and trade data; but it also offers analytical reviews of the region, sector-by-sector analyses of the major industries, and a section that focuses on ideas for future directions for the region. This latter section is entitled "Towards Sustainable Development." To write the book, we subcontracted about ninety different authors, mostly Russians living and working in the regions—a highly interdisciplinary group ranging from geologists to economists to environmentalists. The target audience we envisioned is academics, of course, but also people working in the

region, the business community, and the international development community.

To understand current environmental issues, you have to look at the historical context of how the region was developed. Essentially, the Soviets developed it as a resource periphery, which we have heard about earlier today, and as a strategic military outpost, and these interests were often interrelated. What you had were industrial centers primarily situated along the Trans-Siberian Railroad and the Baikal-Amur Mainline that focused on resource extraction. Further north, you had isolated industrial pockets, or archipelagoes, where entire cities were constructed to extract one or two strategic resources. It was the Gulag economy that was mentioned earlier. You had entire towns constructed in this fashion—with names like Neftegorsk, meaning "oil town," and Ugolgorsk, meaning "coal town," and so on.

When most people think of environmental problems in the former Soviet Union, they think of Chernobyl, of air and water pollution, and of the tremendous waste associated with inefficient production methods. These issues are certainly relevant, but far less known but equally important is the huge intact wilderness that remains largely as a result of this sort of Gulag archipelago-type of development. You still have vast areas of wilderness without roads. As a result, the region has emerged as a major conservation priority for the international environmental community. Russia essentially has the world's largest remaining wilderness on the planet.

Housed within this wilderness is rich biological diversity. I like to use the quote, "The Russian Far East is in fact the most biologically diverse region of the largest country on earth." And there are some particular hot spots worth mentioning in terms of biological diversity, one of which is the Sikhote-Alin mountain range, which straddles Primorsky and Khabarovsk krais. One of the most diverse temperate forests in the world, it is home to the famous Amur Tiger, which is the world's largest cat. Their basic primary habitat is that region, and there are about 350 of them left.

You also have tremendous marine resources. Many people know about the endangered whales from the Sakhalin projects, but there are also other marine species, including endangered ones, that live within those waters. More than

"The Russian Far East is in fact the most biologically diverse region of the largest country on earth."

one-quarter of the world's salmon spawn in the rivers of Kamchatka. In this intact wilderness, you have a territory of global importance for mitigating climate change. Russia has about 25 percent of the world's remaining intact forests, with a large percentage of them in the Russian Far East, in Eastern Siberia, and, to a lesser degree, in Western Siberia.

You also have a legacy of extraction-based industry. And by that, I mean not just oil and gas and mining, which are what we usually associate with extraction-based industry, but also the fishing and forestry sectors. They belong in the sense that neither has much of a manufacturing base. In fact, during the Soviet era there was much more manufacturing capacity. Now it is basically at pre-1980 levels.

One of the new changes for the region in the post-Soviet era is a shift from a resource base for the Soviet Union to one for Northeast Asia. Essentially, the Chinese, Japanese, Korean, and, to a much lesser degree, U.S. markets virtually control the development trajectory of the Russian Far East. It is this sort of resource demand, coupled with the unsustainable sort of raw material export dependence of the economy, and further combined with the inability of the Russian government to properly regulate its resources, which is the underlying cause of environmental degradation in the region. There are many reasons for the Russian government's inability to regulate resources. Bob talked about the close connections between the government and criminal interests. It also stems from the gutting of funding for the environmental regulatory agencies. The Committee on Ecology, really the only independent oversight agency, was abolished in 2000 and its responsibilities were folded into the Committee on Natural Resources.

To give you an idea of my underlying thesis, I am going to use the timber industry as an example. In this industry, we have seen a collapse of processing and a reorientation towards the Chinese market in particular. This is a fairly recent shift. As a result of the 1998 logging ban in China that greatly restricted timber production in its Northeast, China is now the world's second largest importer of timber, and Russia supplies about 40 percent of that total. Last year, Russia exported about 15 million cubic meters, at least on the books, to China. This is three times the size of Japanese timber imports. It is a

massive shift, and it is putting pressure on Russian forests.

You also have the fragmentation of industry. This is specific perhaps to fishing and forestry, and maybe less so in mining, oil, and gas. But the fragmentation has resulted in a sharp increase in the number of logging operators and exporters. It is becoming extremely difficult for the Russian government to regulate these numerous operators. As a result, there is widespread illegal logging. This takes place not only in areas where there should be logging, but also in protected areas along river systems. It also has resulted in the over-harvest of endangered species that have commercial value on the Asian markets.

I just spent about 35 days traveling in Siberia, the Russian Far East, and China tracking illegal logging and documenting the Russian-Chinese trade. On this trip I documented an illegal logging site that is right on a protected river that flows into Lake Baikal, in a river basin where there should not be any logging. The loggers are basically taking the meat of the tree (the section with the largest diameter), because that is the only part that has commercial value. The rest remains. This is not only incredibly wasteful, but the unwanted timber dries up, fueling forest fires. This is a major environmental issue in the Russian Far East. The Forest Service, and we visited a local branch in Baikal, is now a major commercial logger in addition to supposedly regulating logging companies. This is due in part to the decline in funding for these agencies. Essentially, they are using a loophole in Russian regulation known as "salvage logging" to log commercially. They either do it themselves or they outsource to small logging companies with whom they have connections.

We then tracked the timber from the logging site to the Russian-Chinese border. It is essentially a consolidation area that is controlled entirely by Chinese entrepreneurs in coordination with some Russian criminal interests and the provincial government, which provides the umbrella for such activity. We then tracked the timber to Manzhouli, on the Chinese side of the border, southeast of the Chita region in Eastern Siberia. It has the largest loading facility I have ever seen. They consolidate the timber there and then export it to various parts of China for processing. The processing facilities in Manzhouli, which have sprouted up incredibly in the last ten

years, focus almost entirely on processing Russian timber. They have drying capacity, and they work 24/7 to produce sawn wood and furniture both for domestic consumption and for use in international export. This is an emerging, and I would argue unsustainable, development model where Russia exports its resources, often illegally, and then the value-added activity occurs in China, which creates jobs. The finished product is then exported from China throughout the world.

The same thing has happened in the fishing industry. There is a reorientation towards the export markets—Japan, China, and others. There is a similar loss of processing capability and fragmentation in the industry, where you have a number of small operators, making regulation much more difficult. There is the same kind of market involvement by the regulatory agencies. In this case, it is the Pacific Research Institute of the Fishing Industry and Oceanography (TINRO) that is responsible for determining the fishing quotas in the Russian Far East, but is actually selling the quotas as well as harvesting and selling the fish illegally. As a result, you have the uncontrolled harvest of species in demand, specifically on export markets—crab, pollock, sea urchin, and sea cucumber, the latter of which has been almost eradicated in southern Primorye. This is leading to temporary closures of fishing areas and severe harvest restrictions in the Russian Far East. The government is taking steps in this area, with partial success.

My basic thesis, then, is that you need to develop a value-added processing capacity in the Russian Far East. The current economy is not sustainable environmentally or economically. To take the timber example again, there is evidence that you would use fewer resources to secure the same amount of revenue. If you are processing the timber, you do not need as much of it to secure the same amount of income. This might reduce pressure to open up these frontier forest areas, and you would of course reduce the waste. The 40 to 60 percent of the tree that now remains at the logging site could be used for plywood, for sawn wood, or for chips, which would help reduce the fire danger. You could also reduce illegality. There is a lot of debate about this, but the argument essentially is that if you locate the processing facility closer to where the logging is, you will be able to track who is

logging. Right now, it is very difficult to separate what is illegally logged timber from what is legally logged. Finally, you would employ more people, and therefore perhaps fewer would resort to illegal resource extraction and poaching of endangered species, which has also become a major problem in the Far East.

The economic benefits are greater revenues. If you diversify the economic base, you provide jobs. In providing jobs, you might also address some of the population outflow that we have heard about in the Russian Far East. You might provide more territorial security because you are improving the quality of life. Ultimately, this might address one of Moscow's major concerns in terms of Russian–Chinese relations and territorial control of the region.

There are constraints to developing manufacturing capacity. We have heard about corruption, which is really endemic. There is manufacturing competition in Northeast Asia, as the example of the Chinese processing facility shows. And there is the issue of investment. Where will it come from? Moscow seems largely indifferent in terms of developing a manufacturing base in the Russian Far East. Some skeptics think that this is perhaps because they want to keep the region dependent on Moscow, and that if there were a better quality of life and greater economic independence, it could reduce Moscow's control over the region in some respects.

In terms of foreign investment, there has not been that much. It has gone primarily to extractive sectors—Sakhalin oil and gas, mining, and, to a much lesser degree, logging and fishing—and not to manufacturing. The bulk of the international financial institutional support has not gone into manufacturing either, despite World Bank claims that one of its major goals is to develop manufacturing. It has essentially gone into foreign-controlled energy and mining projects. But I think it is possible. There are examples where you have processing, both of timber and of fish. And I think that with proper investment and control, you could have successful business ventures in the region.

Environmental problems in Russia are important not only for Russians or for the Russian Far East—they have global implications as well. Mike Bradshaw has been helping me a lot in terms of thinking about this in terms of the emerging school of thought on

Environmental problems in Russia are important not only for Russians or for the Russian Far East—they have global implications as well.

environmental security. That concept was popularized by Robert Kaplan's 1994 *Atlantic Monthly* article, "The Coming Anarchy," which essentially argued that the environmental security issues would be *the* national security issue in the future. I am not sure in the post-9/11 world whether that is really true anymore, but they nevertheless do play a role (and will play a greater one in the future) in national and international security.

In thinking of environmental problems in the context of global, regional, and local concerns, there is obviously the issue of climate change. In this context, what Russia does to its forests, particularly the larch forests, which grow on permafrost and are an emerging source of fiber for the Japanese and Chinese plywood industries, is a crucial issue that will affect the globe. We have to pay attention to how Russia is managing its resources.

There is the issue of natural gas for China and Japan, which offer potentially huge benefits in terms of reducing carbon dioxide emissions. But this needs to be done in the context of both providing energy security for Northeast Asia and for the Russian Far East, which also continues to burn coal. There is the issue of biodiversity and the endangered species, where we have a moral commitment to protect endangered species. There is the issue of fresh water resources. I am encompassing Eastern Siberia here, simply because Lake Baikal is in Eastern Siberia and it holds 20 percent of the world's fresh water.

Then there are the regional issues. Most of the trans-boundary environmental issues in Northeast Asia have focused on pollution: air, water, and nuclear. The Japanese are very concerned, of course, about nuclear waste dumping. But I think within this framework there are a lot of other environmental issues that could be addressed, particularly the growing dependence in Japan and China on the Russian Far East's resources, and that these will have to be managed multilaterally.

One example that involves the United States is the issue of the Bering Sea and the over-fishing of pollock, which is obviously a trans-boundary resource, because pollock migrate. It has impacted the U.S. fishing industry greatly and this is a source of potential conflict between the two. That is another example where you

need a multilateral approach to ensure environmental security for all of the countries involved.

Finally, there is local environmental security. This involves preventing the unsustainable harvest of natural resources and promoting the steady sort of sustainable resource harvest that will allow future generations to benefit in the Russian Far East. Thank you.

BLAIR RUBLE Before we take a break, I would like to send people away with some thoughts. We just heard four rather different perspectives on the Russian Far East and how the Russian Far East interrelates with the world around it. It is a long way perhaps from Gene Lawson's sweeping overview of economic opportunities to Josh Newell's environmental concerns. But it does seem to me that in all four presentations there has already emerged an image, at least, of what is happening in this region. And I think we need to explore how accurate the image is in the discussion period.

We see a Russia that is a storehouse of resources that is surrounded by some of the fastest growing and largest economies in the world that have an insatiable demand for those resources, and we see the emergence of a resource-dependent relationship between Russia and its Asian neighbors. When we get to the issues of politics and the environment, we see a shrinkage of time horizons on the part of Russian decision makers, so that their decisions (whether it is the Russian voter trying to be sure that the electricity remains on in the winter, or it is the Russian Forestry Service that is trying to make ends meet) focus on very short-term investments in a region in which there are clear long-term time horizons on the minds of others. So if Russia is going to repatriate value additions to its economy, those time horizons somehow need to become longer.

It may seem that the last two presentations by Bob and Josh really do not leave a great deal of hope for thinking that such an extension of time horizons will occur. But if we reflect back to the first two presentations, Alexander was talking about the infrastructure development investment that has begun, and Gene was talking about the strategic thinking about pipelines. Their presentations suggest that this may be a moment when Russia can undergo some rethinking about its own Far East and its own relationships with its neighbors.

Discussion

Q. *Is it fair to say as the oligarchs and criminals try to legitimate their gains from the 1990s by investing in their companies or entering politics, they are moderating their behavior? Wouldn't it also be fair to say that in the face of a corrupt bureaucracy, the only way to function is to accept some corruption?*

ROBERT ORTTUNG It is true that the more entrenched they become, they operate less like criminals and more like regular businessmen. They start to care about things like property rights. We certainly see that, for example, with the oligarchs—whether or not you think that the oligarchs themselves committed crimes in gaining their wealth, or whether you think they were just operating in a system where there was essentially no rule of law.

As they started to take their money and put it into businesses, you can certainly see that they are becoming much more legitimate, much more interested in creating jobs and providing benefits for society. If you look at the evolution of Mikhail Khodorkovsky, that has become the hot question today in Russia. Most Westerners find themselves, whether they want to or not, defending Khodorkovsky, saying that, “Look, this is a logical evolution,” and “however he got his money in the first place, at least he is trying to do something useful with it in running his company efficiently.” Whereas most Russians say, “Well, no, a criminal is a criminal, and he deserves what he is getting. Even though the court has not proven it one way or another, he is getting what he deserves from Putin.”

But to answer your second question, I would be very pessimistic about it. Certainly, there used to be a lot of work on corruption, which said that corruption is a good thing because if you want to get something done you can always pay somebody. And that is sort of the beginnings of a market economy. People used to say about the Soviet Union that it is good to have corruption to get things done.

But I think over time, scholars who have studied corruption carefully have come to a consensus that it is sort of like sand that wears down the morality of the system. And over time, if you have a corrupt system, even if it is a functioning corrupt system, like, for example, the city of Moscow, it sort of wears away at the

moral basis of everything and it prevents long-term economic development. And I think that there is a real danger in Russia that if you bring criminal capital so quickly into the political and economic systems, there is a long-term danger that it is going to wear down the moral basis for a functioning market economy, and that the negative aspects are going to be a lot more substantial than the positive benefits.

Q. *I have a question for Bob regarding the Vladivostok election. I am just wondering why the federal authorities think they can control Nikolayev? You yourself describe his nickname, or the origins of his nickname, as a sign of how uncontrollable he was. The night after the election, his supporters were shooting off guns in the suburbs of Vladivostok. It almost seemed like a Wild West atmosphere being introduced into that city.*

ROBERT ORTTUNG On the question, why does the Kremlin think it can control Nikolayev? I think that he is not the Kremlin's first choice by a long shot, and so it is reacting to the situation as it is developing. I think that there is a commonality here, however. I was just in Moscow, and I heard a very interesting presentation by Olga Kryshatanovskaya, who has been studying the political elite in Russia and the origins the *siloviki*. She argues that what we see going on in Russia today is a battle between the millionaires and the billionaires. The billionaires are, of course, Khodorkovsky and other folks like that. The millionaires are the people who were in the intelligence services in the early 1990s, who were pushed out when Yeltsin reorganized everything, and who went into private business, where many of them did very well. Those people are now coming back into political power with Putin, and they are what she would describe as the millionaires. I think that those people, having been in private business through the 1990s and now coming back into politics, speak a common language with someone like Nikolayev. He is somebody that they can understand where he is coming from, what he is thinking, and how he operates. In that sense, I think that there is some sort of link between them. Though obviously it would be better not to have someone like Nikolayev there, and they do not particularly want him there, he is somebody that they can work with.

If you bring criminal capital so quickly into the political and economic systems, there is a long-term danger that it is going to wear down the moral basis for a functioning market economy.

Q. Alexander, there was mention about the ability of large Russian companies from the center coming to the Far East and supplanting many of the local smaller businesses. What I would like to ask is how you view that process, whether it is beneficial or whether it is hurting the region?

ALEXANDER FEDOROVSKY You ask about the Russian big companies, who now are now more actively organizing their business in the Russian Far East. This process is based on the following trends. First of all, more and more Russian business is interested in China. But it is not easy for Russian business to penetrate the Chinese economy directly. Russian business, for example beer companies and food companies, organize their business on the Chinese border in Russia in Blagoveshensk, in Khabarovsk. They of course work with the local population, but the local market is limited, and their strategy is to expand their business to China. As for relations between Russian companies from the European portion of the country and local business, I think that now European Russian business is very aggressive, is very strong, and it finds out ways how to cooperate with local authorities.

So for a local business, there is no chance to compete with this aggressive penetration of the European Russian business in the Russian Far East. The other reason, of course, is their resources. I think that the tendency will be for Russian business to continue this policy. Over the last four or five years, Russia business consolidated their operations in the European portion of the country, and they are now beginning to expand. They are expanding in the Commonwealth of Independent States, to East European countries, and now to the Russian Far East in order to control resources and to organize local production in order to tap into the markets of the Northeast Asian countries. This process of course will be very difficult, because YUKOS was the first company to try to realize this kind of policy. And YUKOS did not take into account the political priorities of the country, I believe. This was a conflict between the state, and business. So I mean that it will be efficient only when private business and the government will coordinate their policy.

Q. Josh, you mentioned that the environmental issues were of major concern to the international environ-

mental community. What sort of buy-in is coming from the grassroots?

JOSH NEWELL I think there are the seeds of a very strong grassroots environmental movement, but the major limiting factor so far has been lack of financing. You have not had a professionalization of the ecologists in the sense that they can devote every day to working on environmental issues. The environmental movement is still essentially at the mercy of the international donor community. There have been some instances where the Russian business sector, and to a much more limited degree the Russian governmental sector, are supporting civil society, but it is still very limited. Part of that is because there is really no tax incentive in place in Russia for it to be advantageous for an individual or a business to donate money to a non-profit, unlike here in the United States, where we have a 501(c)3 organizations and you can write your donations off on your tax statement. So that is a major constraint.

The other thing is that most people in the Russian Far East are still very concerned with making a living. We have been talking about resource extraction, but that impacts a very, very small minority of the population, really. There is a tremendous inequality—resource inequality—where you have the mass of the population just trying to put food on their table and take the odd vacation to Thailand or something. There is really much more of a day-to-day concern with economics than environment.

Q. I have a question for Dr. Fedorovsky. It has been mentioned now that demographic changes have been taking place in some parts of the Russian Far East. And particularly in some of these oblasts, the population of the Chinese is perhaps quite significant. There have been cultural developments because of these factors, particularly the Chinese coming into these areas legally and illegally. How is it likely to affect developments between Russia and China ten or fifteen years from now? Are there any geopolitical implications between these two countries? Are these demographic changes likely to create problems between the two countries?

Q. My question links up with the previous one, also for Professor Fedorovsky. I was struck by your characterization of the decision that is being made now in Russia about oil pipeline routes and your prediction

that the Nakhodka route would be favored over the Daqing route to China, and your characterization that it is perhaps the most important decision that President Putin will make in his second term. You referred to Russia's interests in diversification, that is, to diversify the market. And of course, there are sound economic reasons for such a decision in Moscow, if that is indeed the decision that is made. My question is, in your view do you also see a strategic calculus in such a Russian decision? That is, a long-term Russian concern about the trajectory of Chinese power and Chinese influence in that part of the world, and perhaps a Russian view that in the long run that might be a threat to Russian interests in Northeast Asia?

ALEXANDER FEDOROVSKY Thank you very much for both of these very interesting questions. Of course, we would need a long time to discuss Russian-Chinese relations, especially the long-run prospects. Nevertheless, I will try to answer both questions briefly. First of all, I think that the danger of Chinese population penetration into the Russian Far East is very overestimated. I think that the Chinese migrants, legal and illegal, play an insignificant role in the population numerically, but they play an important role in the economic activity in the region. They are concentrated in the most developed areas and they take part in the development of services there. And the services system was underdeveloped in this region, absolutely, under the Soviet period. Second, they are concentrated in agricultural production areas, where they successfully produce food for the local population and for export to China.

Most Chinese migrants transit from the Russian Far East to European Russia and then to Europe. So now most of the Chinese migrants are concentrated in the most developed market centers in Russia—in Moscow, St. Petersburg, some areas in the Volga region and in the Urals region, and some in the Far East. But, strategically thinking, of course it is necessary to take into account the number of the population in the Russian Far East, and the population in the neighboring country. I think that the government has to adopt a pragmatic legal immigration policy not only taking into account China's population, but such people as Koreans—Koreans are also immigrating to the Russian Far East, both from North Korea and

from South Korea. It is also necessary to take into account the Korean population living now in the Central Asian republics, which was deported by Stalin's regime from the Far East. Now they are migrating back to their native land in the Far East and play a very active and positive economic role in the process.

As for the second question, you know, migration is not the most important thing now in Russian-Chinese relations. Nevertheless, I think that both governments might better control this question. I have to stress that regular consultations on this issue have been organized and local authorities are now taking part in the control of this process. I think this question is sometimes stressed by political forces before local elections, for example in the Russian Far East. The issue is especially used by political forces in European Russia in their political discussions.

The other question was on the pipelines and Russia-China relations. You know, of course, there are some delicate issues when we discuss the possible construction of pipelines to Nakhodka. Because previously the possibility of constructing a pipeline from Angarsk to Daqing was very actively discussed. Nevertheless, it is necessary to take into account that there were no government negotiations between the two countries. It was an activity pursued by a private company, YUKOS, only. Officially, Russia, as a government, never promised China to construct a pipeline from Russia, from Angarsk to Daqing. Nevertheless, of course Russia is interested in taking into account China's attitude to this issue. As I know, in China, this issue is discussed very actively. Even housekeepers, even traders in the streets, very actively discuss the possibility of bad Russian policy towards China in the construction of this pipeline. I think that for the Russian government, it is necessary also to have a very delicate policy toward China, and clearly describe the situation. Russia will supply China without any limitations at all, as a leading strategic partner, but also as one of several partners—we have other partners in the region also. Of course, it is a difficult task for Russian foreign economic diplomacy.

But I think that we have no choice, in my mind, because we had a very bad experience in constructing a gas pipeline under the Black Sea to Turkey, where we have only one buyer of this gas who now controls the price. We had a

very difficult experience in negotiations with China on gas prices, and on the future possible supply of gas to the China market—very difficult. The Chinese side insisted on lower prices, and so for Russia it is quite necessary to diversify its export market. China also diversifies their imports of energy resources from different kinds of countries. So it is a quite normal situation. It is necessary to not focus on this problem as some kind of battle between Russia and China. It is necessary to stress and to understand better in both countries that it is only one of the issues between two countries that must be negotiated in order to reach a good decision. Thank you.

Q. *I want to address my question to Josh Newell, and it follows from what we have just been discussing. What is the nature of the Chinese-Russian relationship across the border relating to the processing and movement of raw materials and natural resources? My sense is that there has been an important change in the past year, particularly last month at the Khabarovsk conference, where Governor Ishaev has demanded that if China wants lumber resources from Khabarovsk krai, they have to invest heavily in processing facilities and the lumber must go out processed. The Chinese have accepted that and have agreed to substantial investments, and it has been a major improvement in cross-border relations with Khabarovsk krai. There is really an effort in China to show maximum patience to improve relations and to take into account that they probably will lose the pipeline to Nakhodka. Their goals are more long term, and maybe of all the partners in the Russian Far East they, in particular Heilongjiang province, which is so critical, are prepared to make sacrifices for the time being.*

JOSH NEWELL There has been some movement recently, although it has not yet translated into actual exports of processed timber. These pronouncements by the Khabarovsk government are not really new. In spring 2000, Governor Ishaev announced a raw-log export ban that would require by 2003 that Khabarovsk timber companies export processed timber. Now, of course, this has not come to pass. But Khabarovsk is really on the vanguard in terms of promoting processed wood, so we will see in time, perhaps, whether this will lead to significant Chinese investment in processing. I am a little bit skeptical of it, simply because in

touring the manufacturing and processing facilities in Northeastern China, I saw that there are very ambitious plans for large-scale expansion. That just does not seem to jibe with these other stories we hear of commitments by Chinese investors to invest in Russia. And the owners of these various processing facilities that I talked to were very skeptical and pessimistic about the prospects of investing in Russia because of issues such as corruption, higher labor costs, and because the labor efficiency often is not as high as it is in China. So, we will see. I am hopeful that over time, more of the regions will take the stance that Khabarovsk has taken, and that will slowly help to transform that sector. But I think it is not likely soon, and I am somewhat pessimistic, unfortunately.

Q. *Following up on Robert Ortung's comments, I would note that one of the reasons we give so much attention to Vladivostok is because there is still competition for political power among various groups. You have different organized crime groups that have been fighting each other for years, but you also still have an honest to goodness reform wing headed by Cherepkov that, remarkably, is still vital. Whereas in other parts of the Russian Far East, like in Khabarovsk, there is no competition and the nexus between criminality and governance is mature. I remember very well in helping to establish the U.S. Consulate in Vladivostok twelve years ago, that everything we have been discussing here today was very much underway then—the fisheries, the importation of automobiles, the cross-border trade with China. I saw that twelve years ago, along with the violence and the conspicuous wealth. This had blossomed even while Vladivostok was a closed city during the Gorbachev era. It was quite clear, and we were told this very candidly, that the organized crime groups had been organized essentially decades if not generations before; these were products of the Gulag. So my basic point is that I do not think we are dealing—and I do not say you said this—°with a phenomenon of the transition. We are not dealing with a short-term aberration. We are dealing with a much more deeply entrenched pattern that is the result of the way in which the Far East was settled and developed in czarist times and in Stalinist times. Finally, there is a big difference between businessmen using criminal methods and criminals using business methods. I mean, Jay Gould and Jim Fisk were bastards, but they used violence against their workers, not against each other.*

ROBERT ORTTUNG I think what you say is generally correct. What is interesting about Primorsky krai, as compared to, say, Khabarovsk, is that it has been impossible for anyone to gain control of the situation. It is such a large economy, it is so sophisticated, and there are so many different bits and pieces of it that even Nazdratenko, though he was a relatively strong governor, did not really control everything. There was always an opposition to him, which is not true in a place like Khabarovsk, where the situation is much more under control.

One interesting thing in terms of potential sources of change is that there have been long historical roots for what we see today, as you described. In other Russian regions, the arrival of big Russian business has often played a role for change. For example, I was just in Irkutsk. When you have big Russian companies coming into there, companies like YUKOS or some of the big metal companies or banks, those companies are much bigger than any of the regional players. They have a much stronger influence on the system than any of the local players could possibly have. And in some ways, they have forced more transparency on the local government. So perhaps the arrival of big Russian companies, who do not have a stake in any of the local players, might be able to impose something from the outside.

We have done some research on why businessmen shoot each other in Irkutsk, although not in Vladivostok. We found that if you look at big business, there is relatively little violence, because these companies can afford their own protection services, and so there is sort of a stalemate. The level of violence at big and medium business is relatively low. Where you have the real violence is in small business. And in the case of Irkutsk—and I imagine that it might be similar in the case of Vladivostok—the reason you have violence is that there are various choke points in the economy.

For example, much of the small business in Irkutsk is based on illegal logging. First of all, there are the people who cut down the trees—the workers of the industry who do not get very much money—and there are the people who make the money, the wholesalers. You have violence because wholesalers are fighting with each other, often shooting each other because they

are trying to get access to the guys who cut down the trees, of which there is a limited supply. The second choke point in the economy in Irkutsk is the railways that you need to export your logs to the Asian market. There is only a limited number of railroad cars, and so there is often violence among people trying to gain control of these railroads. Further research might identify why exactly the violence exists in Vladivostok, and what kind of choke points you might find in the economy. That might point to a way to reduce that kind of violence.

Q. *An impression that I had from assignment to Vladivostok about six years ago was that one of the very important issues was the relationship between Moscow and Vladivostok—between the center and the periphery. Many of the people in Vladivostok felt that Moscow played a suffocating role in its supervision of the Far East, that the people in Moscow knew relatively little about the area, that they a difficult time maintaining ties with Moscow because of the distance and communications, and, moreover, that Moscow did not care all that much. In hearing about this criminalization, I wonder whether that could have been a partially a reaction to this divide. My broader question is whether a major element in the development of the Far East is to get a better balance between the center and the periphery—a sharing of roles so that they could get more initiative in Vladivostok and other points in the Far East.*

ROBERT ORTTUNG I think from the Kremlin's point of view under Yeltsin, and Putin holds the same view, was that the Far East is a region that is beyond control of the Kremlin. You had governors, particularly in the case of Nazdratenko, that were beyond the Kremlin's control, and the Kremlin needed to do something. So the typical response was to increase the power of the federal government over the region. I think that this has been Putin's policy for the whole country. I also think that that policy is very wrong-headed. In most regions, I would argue that if you want to get more control over the governor, instead of trying to strengthen the federal government, what you should do is strengthen the mayors. In other words, provide a counterbalance to the governor, or weaken the governor by strengthening the local government, and that will solve the problem with the federal government.

In Vladivostok, obviously it is a difficult situation. Strengthening the local government is not an easy solution, because the local government is completely under the control of the regional government. It is subject to influences by a strong criminal black market in the region. But I think, even though you are going to have results like the election of someone who has been convicted of crimes as mayor, in the long-run, it would make much more sense if you want to have any kind of balance and forward progress to somehow empower more local government there. If you do a more fine-grained analysis of what goes on in Vladivostok, there are lots of examples of civil society groups coming up. I think if there was more of a way for these groups to present their interests in the political system, then you would have more of a balance. But, unfortunately, what you see under Putin is the imposition of the “vertical of power.” With the adoption of local government reforms that will go into effect in 2006, you are going to have increasingly less power at the municipal level. All that power has shifted up to the regional and federal levels.

Again, my conclusions are rather pessimistic, because what might potentially be a solution, although not one that is very easy to achieve, is now being blocked out by the centralization policies of the federal government.

Q. This is to Josh Newell. I am looking at the environmental aspects of what you were discussing and I found it fascinating and very disturbing. And the reason I find it particularly disturbing is that I am not sure you can do anything about it as long as China, and to some extent India, are growing as rapidly as they are growing. Even if you had the most well developed, well thought-out environmental restrictions about logging—when you have an economy that is growing as rapidly as China is, or India is now beginning to do, and they are very much involved in the production of furniture—how are you going to impose limits on that kind of thing? This goes right back again into the case of corruption. I do not know what you do—you cannot say, “I surrender.” I do not know how the Russians can manage to enforce their controls when it is such a large territory.

JOSH NEWELL I think really what you were asking are two somewhat separate but connected questions. The first is how to exert influence

over the timber industry and how to improve harvest methods. The second is a much broader question of the issue of finite resources. Even though forests are renewable resources, the rate of consumption is such that it may completely degrade the resource.

In terms of the first one, as you mentioned, China is growing rapidly, and its demand is growing rapidly. But missing in that equation is the fact they are producing furniture for the international market. So it is not necessarily only a Chinese consumption issue, it is more of a global consumption issue, and it is part of the global economic system. One way to exert influence is via the furniture suppliers. If you take the example of Ikea, for instance, which has a very progressive environmental mandate, you could exert influence by having Ikea require that its Chinese suppliers only use timber from sustainably harvested sources and that they source the timber back to legal operations. If you could do that, you would have a ripple effect back into Russia, which would absolutely require some sort of sustainable resource management. This, to me, is really one of the only ways to address the issue. It is actually from the end user relying on major purchasers. That would in turn force the Chinese suppliers to identify where their wood is coming from.

In terms of the larger issue of finite resources, that is a tricky one, and really relates to our over-consumption of resources. I do not have any easy answer for that, except to say that we have to maximize efficiency in all areas in terms of our production methods and simultaneously try to reduce consumption of wood products. The other possibility is perhaps to develop large-scale plantations in an effort to conserve some of the remaining frontier forests. There are many complicated issues involving plantations. Wood quality is one; the heavy use of water is another. There are a lot of environmental dimensions to it, which I do not want to go into detail here. But there is really no easy answer to your last question on the finite resource base.

BLAIR RUBLE I would like to close with a question I hesitate to ask for a couple of reasons. One, it could lead us into hermeneutics, which we should avoid here. And secondly, it may say more about each of the panelists than the reality on the ground.

In listening to the discussion, I was struck by two competing visions of what is driving development in the Russian Far East and in the entire region. One goes back to comments about long-standing historical settlement patterns, the kind of economy that exists today as a result of previous policies—of czarist policies and of Stalinist policies. The other reflects a powerful dynamism that is existing if not within Russia, then outside of Russia: Chinese demand, South Asian economic development, issues of migrants, and the fact that the population of this region may not even look like what it looks like now in twenty years.

So I want to try to focus some attention on these two competing images and ask more concretely: If we look at the end of the presidential term of the next Russian president, which in theory would be eight or twelve years from now, what will this region look like? Will the issues that a Kennan Institute conference would focus on be those of immigration, those of the economic dynamism brought by increasing demand for Russian finished products from Asian markets? Or will we still be talking about, as we were twelve years ago, illegal fishing and lumber shipments that are controlled by a Russian mob that has taken control of government? Ten or fifteen years from now, which is the more likely outcome? That these international forces are indeed going to change the way this region works? Or are the weight of history and traditional Russian ways of doing things just going to keep things in place? We will start with Alexander.

ALEXANDER FEDOROVSKY I think that a lot of things will depend on the continuation of reforms in Russia and the growth of Russian big business. I think that it is a great simplification to say that the Kremlin, or the *siloviki*, or something else controls everything in this country. I think that the people were disillusioned with the communist system and then were disillusioned with the market reforms. But now they begin to see the results of these reforms. And it is a pity that sometimes they think that these good results come from the commercial or political activities of criminal groups. I think that the real alternative to this criminalization of the economy is big business.

Take as an example the forestry industry as one of the areas marked by criminalization. Big

businesses lobbied for a new laws on forestry, which could lead them to invest huge amounts in this industry. Some local business groups and politicians in the State Duma opposed this law aggressively. They opposed this law because they were afraid that they would disappear from this business. I believe that this year or maybe next year the State Duma will adopt this new law, and huge groups from the European part, from Western Siberia, will occupy leading positions in this industry in the Far East. They will reclaim this industry from these corrupting groups and illegal businesses. I think that if this trend of reforms continues, and the businesses in Russia continue to grow, we will have a chance to see a positive change in the Russian economy in this area, and Russia will be more and more integrated with the economies of its neighboring countries.

ROBERT ORTTUNG One way to approach this difficult question is to look at what are the potential sources of change. The situation that we see today has been in place for a long time. What are the sources of change? One possibility is big business. I think that it is really one of the most likely sources of change, too. But I was doing research in Irkutsk, trying to examine this question, and what everyone kept saying to me there was that big business has not had an impact on the local rule of law situation because of the tax system. Big business comes into a particular region and starts working there. But they are still registered in Moscow or in some other region and so most of their taxes get sucked out of the region. In the case of big business, most of the time 60 percent of their taxes would go to Moscow, something like 25 percent would go to the regional government, and 15 percent would go to the local government. It does not really provide much of an incentive for anybody to make any changes to the way the system operates at the local level, because all that money is sucked back to Moscow. That is sort of where things are heading under Putin.

Another source of change would be local government and local grassroots change. But again, you do not really see that the current system is encouraging that kind of thing. Given the greater concentration of power, it is hard to find any potential sources of change that would make the situation any different ten years from

now. You do not see, for example, the rise of an industry that could provide jobs in sectors beyond the energy sector. You see some small businesses rising up, but the main problem for small business in Russia is municipal government. The municipal government situation is not going to change. Nikolayev says that he understands small businessmen because he used to be one, and he is going to remove all barriers for their development. But it is hard to imagine that that is going to happen. So, if there is not much hope for big business, small business, or grassroots change, it is hard to see how anything is going to be different in ten or fifteen years.

JOSH NEWELL I do not want to be overly pessimistic here, but I want to go back to the issue of bringing in big groups into major resource sectors in the Russian Far East. I do not think that will solve the issues facing the region by itself. Looking at the forest sector again, you can reduce the illegal logging, but

unless you transform the structure of the industry from a raw material supplier to timber processing, I do not see much hope at least in terms of reducing environmental impact. I also think that extends, as I have argued in my presentation, to the economy as well and to the stability of the region. That leads into the endemic problem of short-term thinking in Russia, where you do not know what tomorrow is still going to bring, and that dissuades long-term investments in processing and other areas. I think a major requirement is having enough stability in the country so that you can invest and you can look beyond just cutting some logs and exporting them to make money. In time, I think that will happen. I am hopeful that perhaps some of these criminal elements will legitimize themselves over time, and invest long-term in the region, because I think that is really what the region needs from an economic, a social, and an environmental viewpoint.

RFE-Asia Energy Trade as an Engine of Integration: Not a Done Deal

Panel 2

PAUL RODZIANKO I would like to begin this panel by touching on the conclusions from this morning concerning what this region is going to look like in ten years. One of the answers was that big business is going to make a difference. Another answer was nothing is going to make a difference, if that is the correct paraphrasing. And the third was sort of in between. So, I consider they had a tie score in that inning as to the outcome. In this panel, we would like to add some layers, some dimensions, and some texture to the overall situation. I think that it is a long, long distance from Kovykta, in Eastern Siberia, all the way to Sakhalin, and there will be different kinds of infrastructure that will be needed for each of these energy-producing provinces. There will also be different ways in which these developments will be supported by financial capital, technical capital, and human capital. I think we will approach the question from the standpoint of what does the energy sector look like throughout this area, and what is the nature of the people who will make it happen in this area? That is one of the directions we may want to go. I would like to start off with Shawn McCormick on East Siberia and the resources potential in that region.

SHAWN MCCORMICK I would like to start off with a little information about the company that I work for to give you some context as we move into this discussion about East Siberia. TNK-BP is a relatively new company. We just started work on September 1st last year with a combination of assets from TNK, Sidanko, and BP in Russia joined into a new venture. We have a range of assets across the country that we now operate and are seeking to develop. The specific project I want to talk to you about today is called Kovykta, and it is in East Siberia, near the Irkutsk region. It is a gas field with about 70 trillion cubic feet of gas. It is a tremendously challenging project from a technological perspective, but perhaps more importantly in many regards, politically.

We see some very encouraging signs from our discussions with Gazprom to help move it

forward, as well as with the Chinese and South Korean governments and the Russian government. We believe that now there is a real chance of this project going ahead, and also in time to allow Russian pipeline gas to take advantage of market opportunities over the next couple of years.

We are the third largest oil and gas company in Russia now. With recent political events, we might become the second very soon. Our business and investment strategy are focused on the long term. We are developing a new type of company in Russia that embraces the best of international and Russian practice and experience. This is a new concept, and what we are doing is a new concept for Russia as well. It is important to recall that the Russian oil industry has been isolated from the global mainstream for many decades, and we are in the process now of helping to reconnect it to the global market.

In terms of the company's upstream oil production, it is a split: 2/3 in Western Siberia, and 1/3 in the Volga and Urals. In addition to our core production areas, we have a number of potential new projects, or Greenfield developments. We also have quite a hearty downstream presence in the country, with five refineries in Russia, one in Ukraine, and 2,100 branded retail outlets, or gas stations as we call them in this country. We are spread across nine time zones in Russia, and we have about nine billion barrels of reserves with a few tens of billions more sitting behind that, which we are hoping to develop and bring on as provable reserves.

With the application of new technologies, we are discovering reserves in areas that were previously considered well known, and that is one of the things that this new company is doing. For example Samotlor, which is in Western Siberia, is the third largest oil field ever discovered in the world, and we are producing over 400,000 barrels a day on this. By looking at the seismic data differently, much to our surprise, an extra billion barrels of oil was found in a structure that has been in operation since the late 1960s. So there is a lot that can be done on Brownfield assets as well as the new Greenfield

assets. The bottom line is that no matter what you think you know about Russia, in terms of its reserves and its production, there is a lot more to come in the future. It is not a stagnant story.

Russia has a dominant position in supplying gas to Europe, providing about 22 percent of European supply. With the introduction of European gas directives and an increase of supply from other countries, such as Norway, North Africa, the Caspian, the Middle East and elsewhere, the growth for Russian gas in the European market is going to be constrained. The Europeans are also concerned about becoming overly dependent on any one source,

especially as their domestic supplies continue to be tapped out. Over the next twenty years, however, growth in natural gas demand in Asia is set to outstrip other regional markets. Growing gas consumption in China, for example, could increase, as we see it, to potentially 130 billion cubic meters annually (BCMA) by 2015. This would drastically change the gas supply demand balance in Northeast Asia, and more broadly in the Asia-Pacific region as a whole. I think it is important to note that the United States is part of that.

From a diversity and security of supply perspective, Russian gas needs to take its natural share of the Asia-Pacific markets, and this requires the early development of new sources of supply. TNK-BP, like the Russian double-headed eagle, looks west and east. East Siberian gas resources are ideally placed to meet the growing Northeast Asian demand. Opening up a new Asia-Pacific export route for Russian gas is critical for future regional gas balance and development. Significantly, Russian gas sales to Northeast Asia, China, and Korea could support the revitalization of Eastern Siberia as a whole and be a foundation for further regional development.

Northeastern Asia's fast-growing markets are the most logical targets for East Siberian gas. Chinese annual demand is growing at about 12 percent a year and South Korea's is growing at about 5.5 percent a year. PetroChina and CNPC (China National Petroleum Corporation) currently dominate the Chinese market, and liquid natural gas (LNG) supplies into China will commence shortly. Domestic gas is also an important part of that mix, but there are shortages already and we are hopeful that our project can supply a percentage of that. Our data show that China and South Korea will have considerable shortages in gas supply over the coming ten to fifteen years. Key gas policy purchase commitment decisions will have to be taken by the end of 2004 in these countries. A market window exists in both countries in 2008 to 2011, which is why decisions will be taken early to get the supplies there. (Figure 1 and 2.) We think the competition will be between Russian pipeline gas and a variety of LNG options.

With no deliveries of Russian pipeline gas, however, they will choose to rely only on LNG. LNG supplies will increase from places

Figure 1. Market Window in South Korea

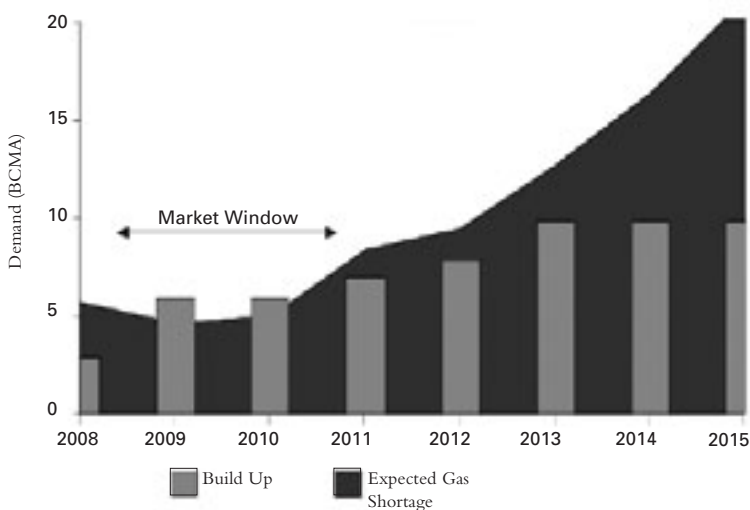
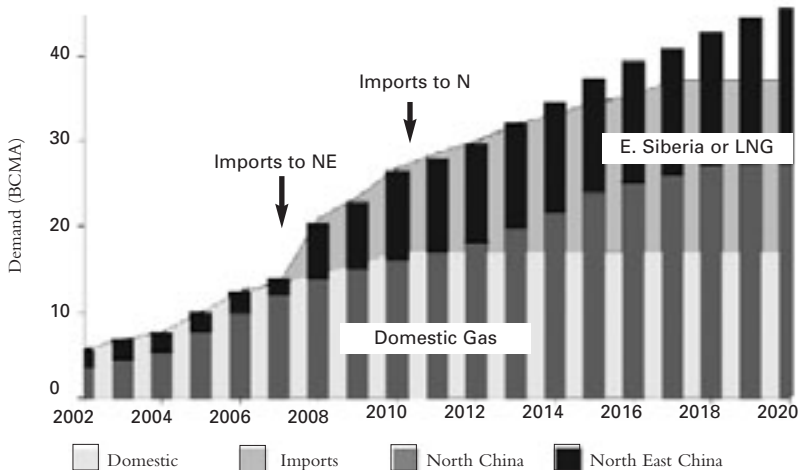


Figure 2. Market Window in China



like Indonesia, Australia, and the Middle East, which necessarily reduces the options of having those LNG sources available to supply the West Coast of the United States. This is where Kovykta in Eastern Siberia can impact U.S. energy security, partly because Kovykta gas will not be turned into LNG. The only viable option for Kovykta, in terms of the cost and price structures, is pipeline gas. If we miss this window that is before us now, through the end of this year and perhaps into early next year, the next available opportunity to access these markets, given the market windows and the timing in the gas sectors, are probably at least a decade or more away.

Next I would like to discuss our reserves. And if you look at our numbers you will see: 70 trillion cubic feet (TCF) of gas, 6 billion barrels of oil, and almost 2 billion barrels of condensate, all untapped. There is virtually nowhere in the world that you can go today and find these sorts of volumes of oil and gas. Companies are spending billions, in some cases tens of billions of dollars, to get shares, even percentages of shares, like this—in the Gulf of Guinea, for example, which is considered a hot prospect, or deep water Gulf of Mexico. And here we have it sitting in Eastern Siberia waiting to be tapped.

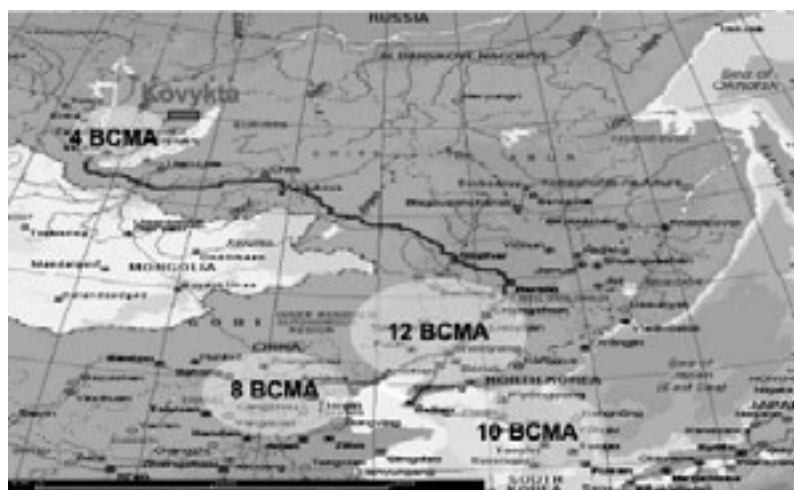
The field that I want to talk to you about today specifically is called Kovykta or Kovyktinskoye. It is sitting in a pocket of major gas discoveries. And it is the sheer size of this project and its potential development that makes it the only field here capable of meeting the emerging market opportunity in Northeastern Asia in the 2008–10 window. Kovykta reserves could be an anchor for an eastward pipeline export route, but there is also the potential of some of it going west to fill gaps in supply for Europe that Gazprom said that they anticipate. Our discussions with Gazprom on gas export are ongoing. Clearly the “Ministry of Gas” needs to be consulted, and we are consulting it heavily about the way to take this forward and to do our project in cooperation with Gazprom. Relatively near to Kovykta is a field called Chayandinskoye, which Gazprom has laid claim to. There is a concern that if Kovykta gets developed with its massive reserves, then perhaps their field would take another 10, 15, or 20 years to get developed. We are in active ongoing

discussions with Gazprom about maximization of the entire resource basin in this area with an eye towards export markets. Post-2010 Eastern Siberia, we believe, can become a major hydrocarbon-producing province consistent with the overall Russian energy strategy, but the key steps have to be taken now.

The necessary pipeline would begin at the Kovykta gas field, with its 70 trillion cubic feet of gas. When I joined the industry, I asked someone to explain to me what a trillion cubic feet of gas means, and the best way to explain it is a parallel. If you look at the American energy security strategy, one of the keys is gas from Canada. Canada, the entire nation, has 56 trillion cubic feet. This one field has 70. It gives you a frame of reference of what we are talking about here. The license for this field is held by Rusiya Petroleum, in which TNK-BP is the majority shareholder at 62 percent. The field is both technically and economically viable. We have done a tremendous amount of work proving up the reserves that are out there so that we know what we have to deal with. The work behind this international feasibility to date includes eleven volumes of work and 5,000 pages of documentation. This is not a political pipeline; this is a resource looking for a market.

We are looking, according to the study, to get the first gas into the local market in 2006 at a level of four BCMA, and then into China by 2008/2009. Production would then rise to a plateau of 30 BCMA into the Chinese and Korean markets. **(Figure 3.)** I can also tell you

Figure 3. Proposed Pipeline Route



The scale of this project also means that we are not looking at this as a short-term plan. This is a 40–50 year project.

that as the planned pipeline runs down into Korea, there used to be plan for the line going directly through North Korea to South Korea. So while I say this is an economic project, there are politics involved. We have been told at various times to draw the line through North Korea, and other times to take it under the sea. Right now it is still under the sea, and that is where we are going to keep it now. But clearly, the opportunity for a steady, reliable source of gas at market rates could provide opportunities if the political situation matures there in a positive way.

The length of this pipeline is 4,800 kilometers—which is a little bit further than from Washington, D.C. to Seattle. The cost to fully develop the pipeline is \$18 billion. This would be one of the largest non-defense-related projects in the world if we are able to get this thing off the ground, and there is increasing confidence that we will be able to do that.

I mentioned that the first phase is regional gasification. An analysis of the energy market in the Angarsk and Irkutsk region has identified a total market starting at four and perhaps moving up to seven BMCA. This would displace coal in the local market. We heard earlier in Josh's presentation about gas being better environmentally than coal in terms of carbon dioxide emissions. We can beat the price for coal locally produced in Russia, and we can also beat the price of coal locally produced in China. Kovykta could realistically expect to supply perhaps 2.5 BCMA into the Chinese market by 2008 at prices that are also consistent with what the Russian government says that it would like to see on the local markets.

The regional gasification is a significant infrastructure investment, which is moving ahead now. It is about \$500 million, and it can provide a platform for the future of sustainable growth and development of the fields overall. Kovykta will not realize its full potential as a significant contributor to Russia or its investors on the basis of a stand-alone gas project. This is Phase 1 of a three-phase project—China and Korea being the others.

In conclusion, let me make a few points. Timing is everything. If the project does not go ahead in the timeframe that is available to us, which is about eight or nine months now, China is going to have to focus solely on building LNG facilities. And the Kovykta gas will simply sit in the ground. There is no other market for it.

Kovykta LNG is not cost effective, and it is going to sit there probably for at least another decade until the next window opens up in the Chinese and South Korea marketplaces for energy.

The scale of this project also means that we are not looking at this as a short-term plan. This is a 40–50 year project. This is something with a significant time horizon. And it is also part of what we consider to be a win-win scenario for Russia and Russia's relations with the Asia-Pacific region, delivering increased economic integration, prosperity, and stability. For Russia, we think it will also help to attract additional foreign investments, increase tax revenues, of course, provide employment opportunities both in the construction phase and when the pipeline is up and running. It will also increase the supply of clean energy to Eastern Siberia, China, and South Korea.

The project needs a lot of political will to make it happen, as well as the economic work and the technical work that we talked about. We now believe that we are closer than ever to making this a reality, and I hope I have put this project into a bit of perspective in the context of Eastern Siberia, and look forward to the comments and questions later. Thank you very much.

MICHAEL BRADSHAW I am going to focus specifically on Sakhalin and on the Russian Far East. I should say as a proviso that I have always noticed at presentations that my colleagues who have gone from academia into U.S. government have made that statement that, "These are my own views and not those of the U.S. government." When I give presentations like this, I feel I need to make a somewhat different kind of statement: I do not work for BP, I do not work for Sakhalin Energy, and I do not work for ExxonMobil. I am an independent academic, so what I am presenting is my own work. I say that because on a number of occasions, I have given presentations and the first question I get asked is, "Whom do you work for?" The University of Leicester is the answer.

My interest in the Sakhalin projects actually dates back to my Ph.D. research at the University of British Columbia in the early 1980s. The Sakhalin projects themselves actually date back to the early 1970s and the signing of the compensation agreement between Japan and the USSR. Picking up from some of Blair's comments earli-

er about the drivers, the drivers then were the oil crisis. The concern about security and the concern about reliance on OPEC supplies drove the Japanese to look to the Soviet Union as an alternative source. So, what goes around comes around. Those same drivers still are driving the region today. And of course, thirty years later, we have seen limited progress in making the notion of complementarity between the regions turn into a reality. The one rare area where we have seen progress is on Sakhalin, but you need to remember it has taken thirty years and a legacy of Soviet-Japanese cooperation to make the first Sakhalin projects a reality.

I want to point out that this whole notion of the Russian Far East, or in the past, the Soviet Far East, pinning its economic prosperity on a belief in a complementarity—in a sense that “we have the resources, Northeast Asia doesn’t, therefore, we will do business”—is a common theme that you find in the Soviet publications in the 1970s and 1980s onwards, and later, of course, through the 1990s. There is a question mark over whether or not they have the resources, though clearly they have the resource potential. This is really about realizing new resources, and that is why Sakhalin is so instructive. Perhaps there are lessons to be learned from the Sakhalin experience in terms of turning Kovykta into a reality.

So there is this whole idea that the Russian Far East now is a region whose prosperity relies on increased interaction with the Asia Pacific because it is too far from European markets. We heard a presentation from a Russian expert talking very much in those terms. What I really want to talk about is what does it take to turn a resource potential into a resource reality? And I say the Sakhalin projects are the only case of a large-scale exploration and development project, in this case, involving foreign capital.

I do not need to dwell on the background energy situation since a great deal has already been said. The point has been made about China’s reliance on coal, and how, as China’s energy demand growth continues, we would like to see a shift from coal because of the global consequences. There is also ample potential to grow the gas market in Northeast Asia through Korea and Japan. If you look at global LNG trade, Japan is by far the largest consumer of LNG. This is the latest statistic from the BP

statistical publication: Japan in 2003 accounted for 47.3 percent of global LNG trade, and Northeast Asia in total 67 percent. LNG is traditionally based on long-term contracts, and Japan obviously has a policy of diversifying supply, with Middle Eastern and Southeast Asian suppliers dominating.

But things are changing very rapidly in the global gas market. LNG is traditionally more expensive than pipeline gas, although the costs for the LNG supply chain are coming down. But LNG is a lot more flexible. We heard about the opportunity that Kovykta faces, but if it misses it, then the LNG suppliers will take up the slack. From a geopolitical point of view, LNG perhaps is much more flexible than going for a pipeline. And the pipeline works both ways in terms of tying in a supplier and a consumer.

To summarize the key drivers, in terms of Northeast Asian energy markets and Russia’s role:

- Energy demand is continuing to increase and there is limited local supply.
- Present energy supplies are dependent on the Middle East.
- There is a desire to diversify and to shift from coal to oil to gas.

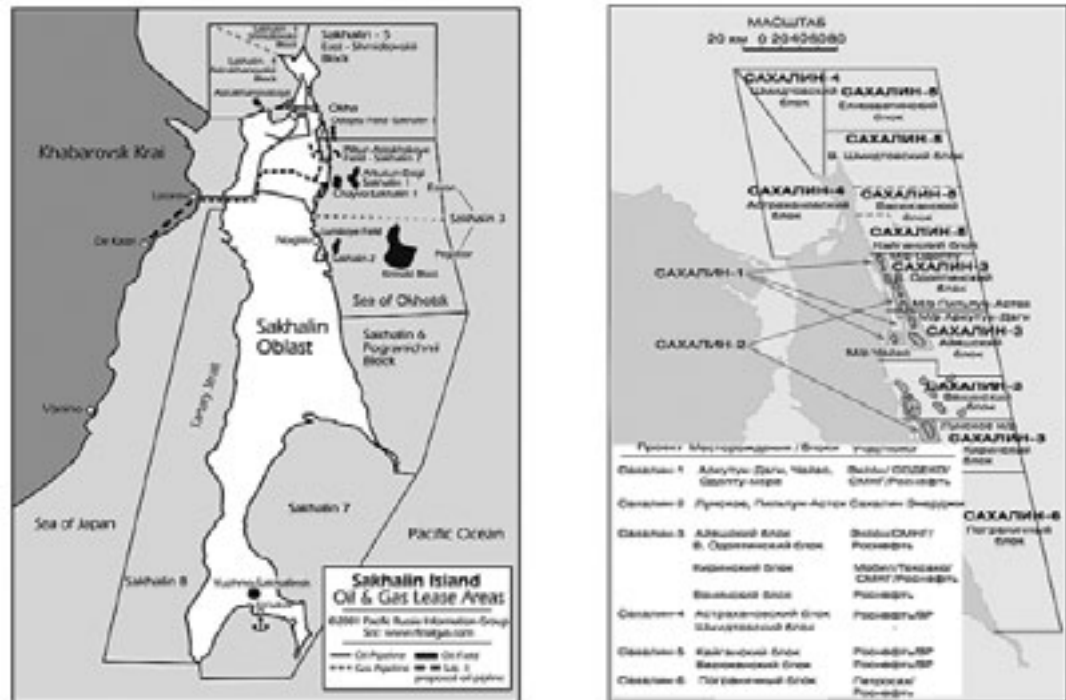
One additional factor in the Japanese context is that problems with their nuclear industry has forced them to look for more sources of gas because they will not be expanding nuclear at the rate they had projected.

Projected increased demand for gas comes both from established LNG customers and new customers like China and India.

East Siberia and the Russian Far East have the potential, in terms of their oil and gas reserves, to satisfy the anticipated growth in demand, and they benefit from proximity. On the face of it, looking at the map, Russia can become a major supplier of energy to Northeast Asia.

Having studied the Sakhalin projects for more years than I care to mention, I can say that it is a constantly shifting landscape. Trying to work out just how many projects there are in existence at any moment in time is in itself a challenge. In **Figure 4** there are two maps, one produced by the Pacific Oil and Gas Report and the other produced from Rosneft’s Website a year or so ago, with quite different views of how many blocks and how many projects there are. According to a TNK-BP

Figure 4. Sakhalin Projects



presentation I heard in London last November, at that time they counted nine Sakhalin projects. I will come back to that figure of nine at the end of my presentation.

There are lots of potential projects, but it is useful to think in terms of generations of projects. What I want to focus on in more detail is what I call the “first generation” Sakhalin projects, and these projects are the ones that date back to the Japanese-Soviet compensation agreement. They are developing fields, which were initially delimited as a consequence of that compensation agreement, and the exploration work was then continued through the 1980s by the local affiliate of Rosneft, Sakhalinmorneftegaz (SMNG). I will refer to them as Sakhalin-1 and Sakhalin-2, and to confuse matters, Sakhalin-2 is further ahead than Sakhalin-1. Over the decade, the corporate structures of the two consortia have changed. In the case of Sakhalin-1, one of the interesting shifts was that Rosneft-SMNG sold its 20 percent share to an Indian interest. In the case of Sakhalin-2, McDermott and Marathon, both U.S. companies, were involved in the project at various stages and have since withdrawn. The Sakhalin-2 project has no Russian involvement: the partners are Shell,

Mitsui and Mitsubishi, and despite its origins, it has no U.S. involvement now. It is very much a project driven by Shell, with the Japanese partners there to provide market. I want to focus initially on Sakhalin-2 and progress to prospects for the future. (Figure 5.)

Now, both of the first-generation Sakhalin projects have pursued early oil strategies—ways to generate an early revenue stream. In 1999, Sakhalin-2 was the first project to produce oil under a production sharing agreement (PSA) in Russia. We talked briefly about the PSAs this morning. There are only three functioning PSAs in Russia, and two of them are the Sakhalin projects. By the end of 2003, more than 6.5 million tons had been exported—first to Japan, Korea, China. Later in 2003, oil was exported to the Philippines, Taiwan, and for the first time, the U.S. West Coast. Production takes place only for six months of the year using the Molikpaq rig, which supplies an offshore tanker that in turn supplies the export tankers. It only operates for six months because of the ice conditions offshore. In 2000, the oil and gas industry accounted for 57.5 percent of Sakhalin’s industrial output, and in 2006, it could be about 80 percent. So far, the Molikpaq has more or less doubled



Sakhalin's oil production. The other half is onshore, and is from depleted fields being developed by Rosneft-SMNG.

The bold move for Shell and Sakhalin-2 was made in May 2003 when they decided to go ahead with Phase 2 of their Sakhalin project. Phase 2 is a \$10 billion project to develop the gas potential offshore. It involves the construction of two additional platforms and pipeline infrastructure to move oil and gas down the spine of the island to an ice-free port where they will be constructing an LNG plant and oil export terminal at Prigorodny. That is what they are doing now. It is an investment of over \$10 billion, and that figure is going up all the time, for two new offshore platforms and an 800-kilometer onshore oil and gas pipeline. This enterprise will initially be owned by a company other than Transneft but, under the terms of the PSA, will eventually return to the control of the local administration and the Russian government. They are constructing the first LNG plant to be built in Russia and two LNG trains, each carrying 4.8 million tons, to get the first gas to the Asia-Pacific. You can clearly see the dash for gas in terms of Russian gas to the Chinese markets and the competition between projects, such as Kovykta and the ice-free oil and gas export terminal.

A number of issues have been thrown up by the PSA in particular. One is the Russian Content requirement, which requires 70 percent of the contracts to be signed with Russian legal entities, and 80 percent of the workforce to be Russians. This has forced Sakhalin Energy to spend a great deal of time going around Russia looking for suppliers. It has forced foreign subcontractors to create joint ventures, to create Russian legal entities, or to create 100 percent foreign-owned subsidiaries registered in Russia to bid for the contracts. The impact of the projects is not just on Sakhalin. Although the late Governor Farkhutdinov used to talk about "Sakhalin-first" when it came to the contracts, Sakhalin simply cannot meet the needs of a project of this scale.

One of the things that Sakhalin Energy is doing now is lobbying to find markets for its LNG. So far, they have signed agreements with four Japanese utility companies for about 35 percent of the anticipated total capacity of the LNG plant. They are looking to China,

Figure 5. First Generation Sakhalin Projects

| | | |
|---|---|--|
|  | <p>SAKHALIN-1 (PSA) Expected investment US \$ 12 billion Estimated reserves 307 mt oil 485 bcm gas</p> | <p>PARTNERS EXXONMOBIL (US) [30%] SODECO (JAPAN) [30%] ROSNEFT-ASTRA (RUSSIA) [8.5%] SMNG-SHELF (RUSSIA) [11.5 %] ONGC VIDESH (INDIA) [20%]</p> |
|  | <p>SAKHALIN-2 (PSA) Expected investment US\$ 12 billion Estimated reserves 600 mt oil 700 bcm gas</p> | <p>PARTNERS SHELL (UK/NETHERLANDS) [55%] MITSUI (JAPAN) [25%] MITSUBISHI (JAPAN) [20%]</p> |

South Korea, and the U.S. West Coast or Mexico as potential markets, and are lobbying very hard, particularly in China. This, again, figures into the discussions about Kovykta and the window of opportunity in terms of realizing new gas demand in the regions.

Sakhalin-1 is behind the Sakhalin-2 project in terms of its own timeline. Initially, in the mid-1990s, the two projects were talking about shared infrastructures and having similar development programs. For various reasons, this has not happened as the two projects have followed different timelines. The Sakhalin-1 project is different to the extent that it has Russian ownership, but ExxonMobil is very much the operator. It also has its Japanese consortium called Sodeco, which has its origins in the original compensation agreement, although this is a reworked version of Sodeco. Sakhalin-1 is following an early oil phase, which is Phase 1 early oil. It is following a somewhat different strategy from Sakhalin Energy's Molikpaq strategy. Instead, its strategy is to use an offshore platform, the Orlan, and conduct onshore horizontal drilling to bring the oil onshore. Then they will convey it by pipeline to Khabarovsk krai, where they are intending to build an export terminal at DeKastri, where they will use ice-strengthened tankers and icebreakers to export oil year-round. This represents a \$5 billion investment. The offshore platform is currently being refurbished and Parker Drilling has built what they say is the world's largest land rig to conduct horizontal drilling some 11 kilometers offshore. This minimizes the need to build offshore platforms.

One of the things to stress, and I am sure that people at ExxonMobil would stress, is that the Sakhalin projects are very demanding technologically. They are really pushing the envelope in terms of offshore operations. The ice conditions, the seismic activity in the region, the typhoons, and the wave heights—all of these things pose major technological challenges.

In the case of Sakhalin Energy, there is an interesting technological challenge imposed on them by the Russian content provisions requiring them to do things in certain ways in order to get more Russian content. For example, they have to build concrete substructures rather than steel substructures because the Russians can build concrete substructures, but not steel ones. The other side of the Russian content rules—and this is not just an issue for Sakhalin-1—is the question of infrastructure. They are developing a multi-billion dollar project in an economy that has experienced a decade of decline and neglect, and which has an underdeveloped infrastructure. Therefore, one of the things that the Russian partners in the form of the local administration expect is that you help to upgrade the infrastructure. One of the solutions is to pay into the so-called Sakhalin Development Fund, which both projects have done or are doing, and the other is to build new physical infrastructure, new roads, new bridges, and to expand the airports. Both projects have built their own office buildings in Yuzhno-Sakhalinsk, and their own housing complexes, but they are also involved in a program of infrastructure upgrades across the island. This is an area where the two projects can and do cooperate.

Multi-billion dollar projects bring with them other actors—in particular, the global environmental NGOs (ENGO), about which we heard something this morning. The Sakhalin projects have found themselves being discussed in the likes of the *Wall Street Journal* and the *New York Times* in less than glowing terms when it comes to environment. One of the Achilles heels, if you like, certainly for the Sakhalin-2 project, has been its desire to get projects financed from international finance agencies, such as the EBRD and OPIC. Such financing requires impact statements and provides an opportunity for environmental lobbyists to get involved. This can lead to improvements, such as Sakhalin-2 first stage's pre-spill response mechanisms.

But there are some highly emotive issues surrounding the projects—not just the Gray Whale, but also the impact of the pipeline route on indigenous peoples, reindeer herders, and the more general impact of the offshore oil and gas activity on fisheries. We have seen the creation of a local ENGO, Sakhalin Environmental Watch, with support, both in terms of organizational support and logistical support, from Western sources. Global projects bring global protests. I think Sakhalin is going to be in the international spotlight for some time to come. At the annual meeting of the EBRD in April in London, they were protesting with a plastic whale, symbolizing the problems that the Sakhalin-2 project posed to the Gray Whales.

One of the things I have skirted over is what has happened to the nine projects? Had I been talking last November at the Sakhalin Oil and Gas Conference in London, we would have been talking about nine projects. Today, I think we are realistically talking about three, maybe four, projects. What has happened? One way to do answer is just to look at some of the principle actors and ask what has happened since November, starting with ExxonMobil. One should also ask ChevronTexaco because it is a partner in the Kirinsky Block Project in Sakhalin-3.

Sakhalin-1's gas pipeline project, which Sakhalin Energy is involved in, is based on the notion of pipeline gas to China and/or Japan. Perhaps the people at ExxonMobil can say more about the status there, but my understanding is that the project is not on hold; it is being reassessed. Of course, if Kovykta becomes a reality in terms of the window identified for the end of 2005, it would have obvious implications for a China route for the ExxonMobil Sakhalin-1 project.

But perhaps more importantly, in the short term at least, is that ExxonMobil and ChevronTexaco have lost their rights to their Sakhalin-3 acreage, including the Kirinsky Block. The Russian government is basically saying that the "PSAs are no longer required, the investment environment is stable. If you want to invest in Russia, you do it under normal the taxation regime." Those so-called second-generation projects associated with Sakhalin-3 are on hold and have yet to be re-tendered. They are not part of the story at the moment, despite ExxonMobil's protests.

Secondly, Rosneft, the Russian partner in many of these projects, has rationalized its Sakhalin portfolio. It has abandoned the Sakhalin-4 project, in which it was, at one point, in partnership with ARCO and then BP. And it has also abandoned the Sakhalin-6 project. Instead, it is focusing its efforts—and here it gets complicated—on its project with BP. And I distinguish here between BP and TNK-BP for reasons that our colleagues in TNK-BP will understand. BP proper, if I can use that term, still has a joint venture on the Sakhalin-5 acreage. They are drilling their first well there this summer, and they have just announced the creation of a joint venture with Rosneft. So that project, which has been developing for a number of years, is making progress. I think Rosneft at least hopes that if the exploration phase is successful, it could see first oil by 2010, although that could be ambitious. TNK-BP have their own Sakhalin project, again part of the Sakhalin-5 block, and they are conducting seismic work on their Sakhalin-5 acreage and plan a first well next summer.

So if you add this into the Sakhalin-1 and the Sakhalin-2 projects, what you see now is that actually the success of Sakhalin is limited to the first-generation projects, those that have their origins 30 years ago and have taken the decade of the 1990s to develop under a PSA regime. Some 1,400 different licenses were required from 40 different agencies, for example, for Sakhalin Energy's first-phase Molikpaq. The bureaucratic costs alone are immense. So first-generation progress has been hard won under relatively positive conditions. The lessons of the Sakhalin projects illustrate the complexities of developing multi-billion dollar projects in Russia. The Sakhalin region is second only to Moscow and Moscow region in terms of FDI in Russia, which tells you something about the rest of the country.

The PSA regime has been critical to the progress of the first-generation projects. Mention was made this morning about chasing the mirage of the PSA. But these are projects with PSAs, and that is one of the reasons why they have progressed. It seems, however, that PSAs have no future offshore of Sakhalin or anywhere else in Russia. The future of the Sakhalin offshore then is uncertain beyond 2005 Sakhalin-1 first oil and 2007 Sakhalin-2 LNG.

What happens after that? This is a key issue, for example, for the service companies who currently have contracts with the first-generation projects. They are interested in whether there is going to be enough business for them there for not just next year or the year after, but for the next decade. Should they create a joint venture? Should they create a presence in Russia and overseas? Many of them had hoped there would be one project following another following another. I think that BP hopes that they will be in a position to pick up the service companies on the tail of Sakhalin-1 and -2. As their contracts and project are being completed, the Sakhalin-5 projects will be starting to develop, and they can benefit from being a latecomer with the necessary infrastructure and some subcontractors.

An optimistic scenario would then be the Sakhalin-5 first oil by the end of the decade, and Sakhalin-1 gas early into the next decade. But the Sakhalin-1 gas, of course, figures in the broader picture of getting access to that Chinese gas market. It may be that, if China follows the LNG option, that Sakhalin Energy will be able to sell LNG into China. The question then becomes how much gas will China be prepared to take from Russia, and will it take so much in LNG that it does not want pipeline gas?

Every time I come to these conferences we keep saying, "We are running out of time. Decisions have to be made." It seems like we have been saying that for at least five or six years. It is interesting to hear the previous speaker talk about a window of opportunity for 2004/2005; I mean, that time is running out. Sakhalin-1 and -2 took 30 years—it cannot really take 30 years again if it is to deliver the kind of benefits the Russian Far East is seeking from increased integration with Northeast Asia. Thank you.

MARSHALL GOLDMAN Russia certainly is very well endowed with energy. But as you have heard in this session and the earlier session, most of the development has been in the west of what used to be the Soviet Union. Now there is a new look to the east, both in terms of development and in terms of customers. We also find that the Asian customers are coming to understand that there is competition for this energy, and not just from China or Japan. There is also, of course, Korea. So there is bound to be tension. The Russians are now coming to

Some 1,400 different licenses were required from 40 different agencies, for example, for Sakhalin Energy's first-phase Molikpaq.

China has now become the second largest consumer of petroleum outside the United States.

appreciate just how valuable their holdings are. For a long time, I do not think there was an appreciation of just what they had. And so that set off a fight within Russia, and I want to talk a little bit about that.

The title of my talk is “The Battle Within Russia and Without Russia for Oil.” There is a fight for control within Russia, which we are seeing played out very dramatically in the last few days over ownership. Where should the energy go? To the customers. That plays into the Asian rivalry, which of course is long-standing, but is also over other issues. So let me first begin with some history, because I think you have to understand a little bit about that.

Energy, oil, has always been in contention. Dan Yergin’s book *The Prize* is entirely devoted to the concern of oil and energy. Dan is not the only one to look at this. Some people say we went into Iraq for a variety of reasons, one of them being to get the oil. Concern about terrorism is not just for the airports, but also for the shipping channels from the Middle East to the Far East.

Now we see the rise of new customers that we never really saw before, especially in Asia. China has now become the second largest consumer of petroleum outside the United States. And what is significant about this is that at this point, China consumes far less petroleum than we do. You can see how rapidly it is growing, and you can see what the implications of that are.

China now imports one-half of its petroleum. Until recently, it was self-sufficient, and indeed, they even exported a certain amount to Japan. They consume about 6 million barrels a day, which is the equivalent of about 300 million tons. Russia has become a major source of supply of imports to China. China is becoming a bigger and bigger consumer, and a more important player. Russia now is indeed the dominant source of supply for the first time. It is not only China, of course. We are also beginning to see now that for years we have overlooked what was happening in India. Now we see India has suddenly caught fire and is beginning to grow.

And of course there is Japan and Korea. I guess you can say we were lucky that until recently, Japan seemed not to be growing. To the extent that they cut back their consumption, China was able to increase their demand without destroying the world’s supply and demand

equation. Korea was also having economic problems, and so to some extent their consumption was not growing either. Japan has now been replaced by China as the second largest consumer of oil. But if you read today’s paper, you will see that the Japanese have announced that their economy is suddenly beginning to grow, which means their demand will increase.

While we see new consumers popping up all over the place, we are beginning to discover that some of the sources of supply that we counted on are now beginning to find it difficult to produce as much as they had been producing. So far, supply has not been cut back. But we are beginning to worry whether the Saudis can indeed continue to be the accordion that expands and contracts according to world demand. There is also the scandal that has affected Shell Oil in Nigeria: Where are those reserves that seemed to be so dominant and so prevalent?

We have to look for new sources. China is very actively looking. Suddenly, the American and the Western oil multinationals are now finding that there are new companies out there that are competing with them. China has begun to look for development rights in Sudan. They are looking to become a player in Iraq, in Latin America, and even in Saudi Arabia for natural gas. The Saudis have allowed China to become a partner in this new development, while freezing out American firms. In the former Soviet Union, they are very active in Kazakhstan, and there have been some quarrels with Russia over who is to get into Kazakhstan. For a time, they were encouraged to bid for control or ownership of Slavneft, until the Russians said, “No, we do not want the Chinese to become an owner of any Russian oil companies this way.” So this has created tension, and these tensions promise to be even more dramatic in the future.

In Asia there have been perennial disputes over who owns what islands off Japan, off Taiwan, off China, off Korea, and in the East China Sea for oil and natural gas. The Chinese have just announced a few months ago to the Japanese that they were going to increase the price of the petroleum they were selling to Japan from some of their interior petroleum fields, as China becomes interested in consuming that oil itself. Now, belatedly, China is beginning to look to Russia in a big way.

Let me now say something about oil in Russia. It is been a fascinating thing to watch oil development over the years, and most of us do not know and do not care that from 1898 to 1901, Russia was the world's largest producer of petroleum. That was before the discoveries in Saudi Arabia and the Middle East generally, when oil production was centered in Baku in the early, early formation of the oil companies.

After the revolution, of course, there was a decline in production. But then production began to grow rapidly until about 1980, when it was very close 550 million tons, of which they exported a substantial portion—205 million tons.

The CIA came out with a report in April 1977, which predicted that in a few years time the Soviet Union would not only have trouble exporting, but also by 1985 would become a major importer of petroleum because they would not be able to produce enough. Well, that did not happen. And one of the interesting things about this is why oil production did not drop. It was in part because of the CIA. When the CIA report came out, it caught the attention of the people in charge of planning, who said: "You know, our Ministry of Oil people are always crazy, they are always calling 'Fire! Fire!' But if the CIA comes out and says we are going to drop production, by God that is going to happen, so we better put more resources into it." So, to some extent, increased investment saved Russian output from dropping.

After 1988, production begins to drop. The breakup of the Soviet Union caused enormous confusion, and the subsequent privatization program helped spawn capital flight by the very people who took over in the privatization. Everybody always refers to the "privatization of Russia." Well, as I titled my book, it was the "piratization of Russia." The pirates took their money outside the country. Khodorkovsky may be in jail, but his money is still outside. Somebody asked—how do you become a millionaire while you are in jail? Well, you start out as a billionaire.

Those in the privatization process were not interested in investing in production, at least not until oil prices tripled after 1998 financial collapse. By 1999, suddenly people like Khodorkovsky said, "Let's invest inside. We cannot make any more money outside the country

than we could make inside the country." That is when oil production began to grow in Russia.

Now, of course, what had been happening was that the privatizers were stripping the assets. And they were stripping the assets not only of the oil companies, but also of the natural gas company. Most of you are probably unaware of the fact that the second largest producer, until recently anyway, of natural gas in Russia was headquartered in Jacksonville, Florida—a company called Itera. This company was a spin-off created by Rem Vyakhirev, the former Head of Gazprom, and Viktor Chernomyrdin, the original creator of the privatized firm Gazprom, for their relatives, wives, mistresses, and children. Until recently, Gazprom's production was dropping, too. Now it is beginning to turn around—Vyakhirev was eventually thrown out and replaced by Alexey Miller and things are picking up a little bit.

There was also asset stripping of the oil companies. There was a fight over Sidanko between Vladimir Potanin and some other investors; now its main production unit is part of a company called TNK. British Petroleum, a minority shareholder in Sidanko, at one point sued TNK. Now, some years later, they are married. You saw the first product of that marriage, TNK-BP, earlier today. And everybody is happy. As far as YUKOS goes, an American investor, Kenneth Dart, lost, I am told, \$2 billion when Mikhail Khodorkovsky stripped YUKOS of its assets in the 1990s.

And then Khodorkovsky took on the Russian state. When you have a \$15 billion net worth as he did, you normally tend to think you are pretty good. In this case, I think he got too uppity. He proposed building a pipeline—as we heard this morning from Alexander, and I am going to repeat some of the things that he said—to China, a 1,400-mile pipeline costing about \$3 billion. YUKOS and Khodorkovsky signed a contract in May 2003 to deliver substantial quantities of petroleum to China—20 million tons by 2005, 30 million tons by 2010. Now the question is how to get it there. You can build a pipeline, or, alternatively, send it by rail. So up until this point, they had been sending it by rail. I have talked to some of the people from YUKOS, and they tell me it is a valid contract and they are delivering on it. Pipeline or not, they will come through. Russian author-

ities, as you heard this morning, instead seem to want to build a much larger pipeline—2,300 miles, almost 1,000 miles longer than the China pipeline—costing \$6 to \$12 billion to Nakhodka. In the rivalry that I described earlier, both the Japanese and the Chinese now say they will finance that. So that makes it much more attractive to the Russians.

Oil of course, is not just from Russia. Kazakhstan is now talking about, or is already building, a crude pipeline from the Caspian Sea to Xinjiang by 2006. The Uzbeks intend to be linked up with that as well.

Now, what is the struggle within China and within Russia? The struggle in Russia is between the state and the private companies. With one exception, the state's Transneft controls all the pipelines. And when Khodorkovsky proposed building his own pipeline, either to China, or to Murmansk, which does not interest us here, with some of the other oil companies, that was really a threat to take over some of Transneft's control. As long as you control the pipelines, you can really determine what the oil companies are going to do.

The state, in the meantime, is interested in redressing what they view as the theft that occurred during the "loans for shares" scheme in the 1990s. I just was in Moscow in April for a meeting at the Audit Chamber, which is headed by Sergei Stepashin. He organized a meeting to consider the "recapture," as economists would say, of some of the economic rent that went to the oligarchs across-the-board, not just in oil. I can tell you on the basis of the conversations that I heard there, what is happening with YUKOS is not unique. Indeed, if I were involved with any of those companies, I would worry about something comparable, either major tax charges or other kinds of devices, plus very extreme anti-trust regulations. The trick is to do it in such a way as not to scare off needed investment for the future. But the revocation of the tender held by ExxonMobil, as Mike mentioned when talking about Sakhalin-3, should not do much to encourage investors.

Of course, if you look back at the experience of other oil companies in Russia, up until this point, it has not been a happy story. White Nights has gone down, more or less; Amoco is being squeezed out; Conoco, Texaco, and a whole long list of companies have gone in and

either have not made money, or indeed have lost substantial amounts. But the oil companies keep coming back, and indeed, even now, they are talking about, "Well, we will be happy to pick up the bones from YUKOS." And when you ask them why, they say, "Well, there is no place else we can go. Do we go to Iraq?" One of them said to me, "Look, if we can operate in Peru with Shining Path on our doorsteps, we can operate with the oligarchs and Putin there."

But, now the question is do the Russians really want foreign investment? Well, there is the case of BP. They agreed to BP. But, in a strange conversation I had with one of the principles of Tyumen Oil, he said that when the deal was finally agreed, the Russian government was not very excited. They saw all this investment, \$6 to \$7 billion, coming in from BP, but they thought the money was going to go to the state, not realizing that it was going to go to the individual owners, the private owners. And so these proposals that are coming—and for a long time there was discussion about ExxonMobil going into YUKOS, or ChevronTexaco—seem now to be tempered just a bit. Or if a company does go in, it needs to make sure that it is a minority share and not a dominant force. Because otherwise, can you imagine Putin waking up one morning and discovering that all his major oil companies are under the control of Western owners. How would you like that? It was bad enough when the Japanese tried to buy Rockefeller Center, though we taught them a lesson in that case. But in the case of the oil companies, that would be something else, with growing nationalism and indeed with what we see now as what you really can call the re-nationalization of YUKOS.

What are the prospects for Asia—for the Japanese, for the Chinese, and the Koreans? Well, the resources are there. But the question is, is there enough for two oil pipelines? I am not taking about the gas, but the oil pipelines. Of course, there is Sakhalin, but that is a separate issue. Is there enough going to be coming from that part of Siberia? The Chinese and the Japanese now recognize that politically there is some question about how reliable it is. It is not perfect. Very often people say, "Well, you do not have to worry about Russian reliability. They sign a contract, they adhere to it." Well, Belarus and Ukraine discovered that the Russians would

stop the flow of gas. And there are other examples of broken contracts: Israel in 1956, Yugoslavia in 1948, and China in 1965. Contract or no contract, the flow was cut off.

Of course, the Russians have also been hurt, and this example is what Alexander Fedorovsky discussed this morning. That is, the Russian experience in Turkey. I think this is very important and I think it is going to determine what happens ultimately with the pipeline to either China or Japan. The Russians built a natural gas pipeline through the Black Sea. Once it was up and ready to operate, the Turks said to Gazprom, "We think your price is too high, and we think you should lower it." Gazprom said, "We are not going to lower it." So the Turks said, "Okay, we will not take the gas." And Russia was left with their pipeline sitting there. To the extent that you build a pipeline to one customer, you are really at the mercy of the customer. Another consideration, while everybody is talking about pipelines, even natural gas pipelines, is that the origin is right around Lake Baikal. The people from Lake Baikal are very much concerned about the environmental implication of what that means. No matter how safe pipelines are built, somehow or other there always seems to be a problem.

What are the lessons in all this? I would argue that politics can triumph over economics, which is not a new discovery, but I think important to recognize here. For the Asian countries, of course, it is not so bad if they can get ahold of Russian oil, so much the better. It will supplement what is coming from the Middle East, and the more options you have, of course, the better off you are. If the Russians should cut off the supply, presumably they are still going to be able to get it from the Middle East; if the Middle East should cut off the supply, presumably they can still get it from the Russians.

The lessons of Turkey are important, because if you build a pipeline that terminates in China, then indeed you are back in the same situation you are with the Turks. Given the tensions that have existed between the Chinese and the Russians in the past, and the bargaining that often takes place between the Chinese and the Russians, it is perfectly reasonable to expect the Chinese to say at one point, "Well, you built the pipeline to us. We think your price is too high, and we are not going to take it unless

you lower the price." And rather than get themselves caught in something like that, the odds are, even though it is more expensive and much longer to build, the Russians will try to build the pipeline to Nakhodka.

But that raises one other question: Who is going to supply the oil? It is nice to have the pipeline, but you have to have somebody putting oil into that pipeline. And given the fact that the private companies now, or at least until two days ago, control most of the oil companies, it is unclear who is going to supply the oil. YUKOS' people have told me that they are committed to supplying their oil to China, and they do not see anybody else out there. I do not know if Tyumen is going to be able to step in, or LUKOIL, or anybody else. As far as I can tell, it is mainly YUKOS that is developing the petroleum in that region. You could find that you have the pipeline up to Japan, but you do not have anybody to put the petroleum in it, because YUKOS is committed, even by train, to supplying China. This may be a subsidiary reason why it is in the interest of the state to take more control over YUKOS, even though it might mean breaking or not honoring the contract with China.

Let me just end with this last idea that may suggest why the Russians are doing what they are doing there. That is, what is this lesson of this? Is this the way to attract new investment? I just cannot resist just telling one Russian joke about how difficult it is to learn lessons from the past and the difficulty the Russians have with this.

Two bear hunters go out into the countryside and decide they want to hunt bears. And to do that, they have to charter a plane. They charter the plane, they go out, each one kills a bear. They bring the bears back to the plane, and then tell the pilot, "Okay. Let's fly back to Moscow." And the pilot says, "You are crazy, you are two big guys and this is a small plane. We are not going to fit in the plane with those two bears." And the first hunter says, "Don't give me that," he says, "you forget last year we chartered your plane as well, and you said you wouldn't do it, and so I gave you an extra \$1,000, and somehow you managed to get everything on board. I will give you \$5,000 this year." "Okay, load the bears in the plane." The bears are loaded in the plane. The plane takes off, and then the plane crashes.

To the extent that you build a pipeline to one customer, you are really at the mercy of the customer.

And a hunter arouses himself, and he says, “Where are we?” and the pilot says, “The same place we crashed last year.”

I have a feeling this is kind of a repeat of that same thing.

NICHOLAS EBERSTADT Over the next few minutes I will be providing a bit of cognitive dissonance for our conference. In contrast to the exciting, perhaps even glowing, prospects we have been learning about for *natural* resource development in the Russian Far East, I am going to be focusing on *human* resources in Russia’s Far East—demographics and population—and here prospects are dismaying, if not dismal. To summarize my presentation: everything negative about demographic trends in Russia today is true of the Russian Far East—only more so.

Russia is already in the grip of pronounced population decline, and the outlook for the foreseeable future is for a continuation of that decline. It does not matter which specialists you ask about this. The U.S. Census Bureau and the United Nations Population Division (UNPD) both anticipate a sharp drop in overall population for the Russian Federation over the quarter century between 2000 and 2025. (**Figure 6.**) So does Goskomstat, for that matter.

But the depopulation that has visited the Russian Federation in recent years is even more accentuated in the Russian Far East. Between its 1989 Census and the 2002 Census, Russia recorded a net population decline of 1.8 million people. Over that same period, what is now the Russian Far East Federal District started out with 8 million people, and ended up with 6.7 million people. By this reckoning, the sparsely populated Russian Far East accounted for about two-thirds of Russia’s total population decline. In proportional terms, the population of the Russian Far East declined by a reported 16 percent between 1989 and 2002. Some of the tabulated demographic declines in the Russian Far East were really extraordinary. Kamchatka’s population, for example, reportedly fell by nearly a fourth between 1989 and 2002; Magadan’s, by over half, and Chukotka’s population, already small in 1989, fell by about two-thirds over the following thirteen years.

Population is in decline in contemporary Russia because the country has experienced a collapse of birth rates and an explosion of death rates since the end of the Communist era. Russian birth rates and fertility levels were none too high in the late-Soviet era; neither were their health levels terribly impressive at that time. What we have seen since then, however, is a truly dramatic divergence in trends. (**Figure 7.**) The birth and death rates intersected in 1992, and the corresponding rates during the last Russian Federation census were about 170 deaths for every 100 births. Last year (2003) the situation was slightly better—“only” 160 deaths for every 100 births. Nevertheless, these are the sorts of disparities one would ordinarily expect to find in times of devastating war or famine. If we only considered the disproportion in the ratio of deaths to births alone, one might think

Figure 6. Projected Total Population: Russia, 2000–2005

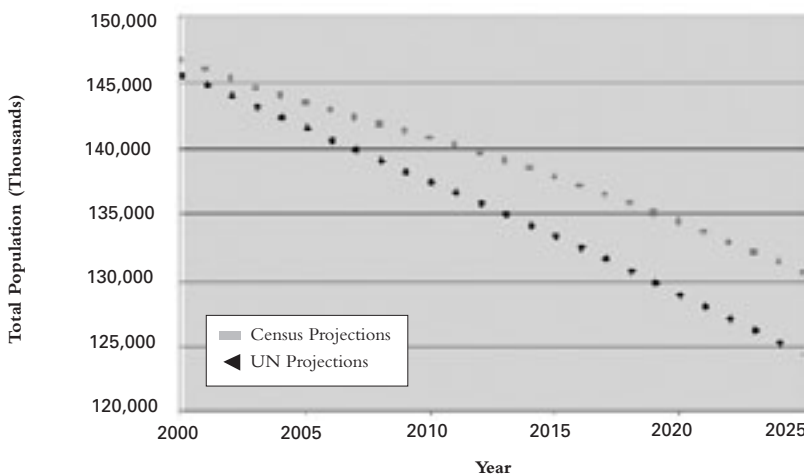
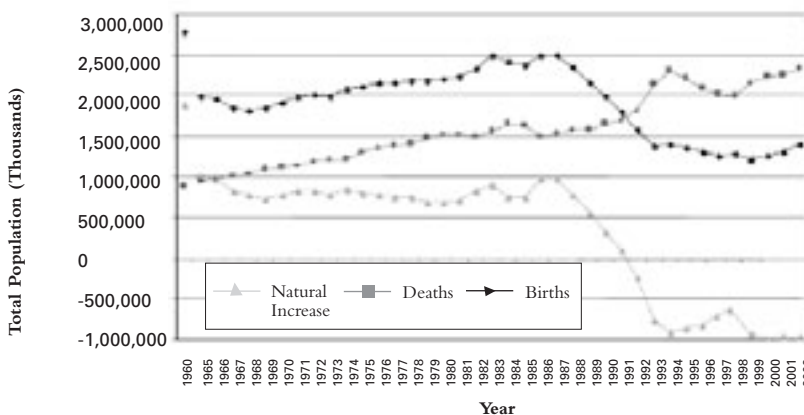


Figure 7. Births, Deaths, & Natural Increase in Population: 1960, 1965, 2002



that we were looking a country in the midst of a terrible, earth-shaking, natural disaster.

If we compare rates of “natural increase”—births minus deaths as a proportion of local population—for the year 2001, you will see that there was only one oblast in the Russian Far East recording more births than deaths. Eight others suffered more deaths than births, although admittedly not in such an extreme disproportion as one finds in other parts of the Russian Federation.

Looking at fertility by oblast, levels in the Russian Far East seem fairly typical of Russia as a whole—but the problem is that for Russia as a whole, current childbearing patterns would today conduce to an average of about 1.3 births per woman per lifetime. The Russian Federation probably needs over 2.2 births per woman per lifetime for long-term population stability, given current female survival patterns. So under current reproductive conditions, one would expect a decline of over a third in size of each successive generation, assuming current trends continue and no net migration.

Anemic fertility levels are one part of the demographic story for contemporary Russia—but extremely low fertility rates are not so unusual in Europe these days. Another part of the demographic story has to do with health—and here Russia’s patterns are exceptional, and exceptionally unfavorable.

The clearest summary measure of health is life expectancy at birth. Russia provides us with a grim “existence proof” that it is possible for long-term health conditions to decline over a 40-year period in an industrialized, literate country that is at peace. Life expectancy for females in Russia today is slightly lower than it was back in 1963–64, and life expectancy at birth for men has fallen by nearly six years over this interim. **(Figure 8.)**

What could possibly account for such an awful retrogression in an urbanized, industrialized, literate society during peacetime? As it happens, there seem to be myriad factors contributing to Russia’s adverse health trends, but after we mention smoking, lack of exercise, poor healthcare, and social inequality, we must never forget our old friend vodka. It is remarkable how closely per capita alcohol consumption and male life expectancy have tracked in relatively recent time periods. **(Figure 9.)**

Figure 8. Life Expectancy at Birth 1958–59, 1961–62, 1963–64, 1965–2003

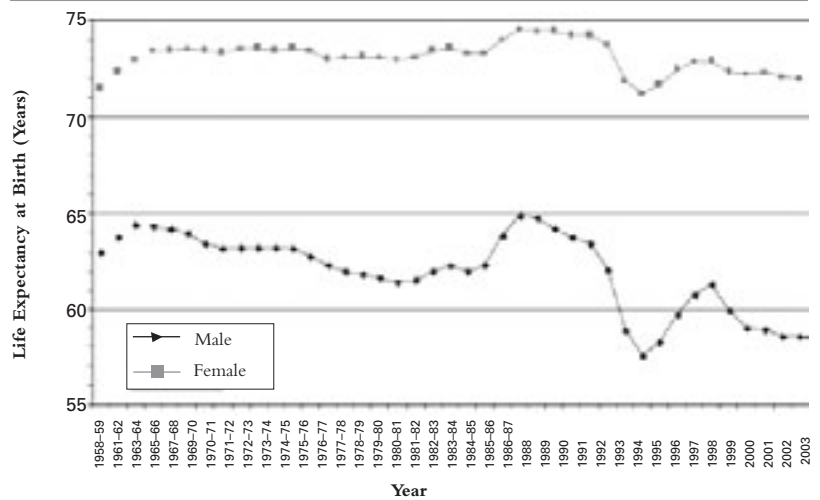
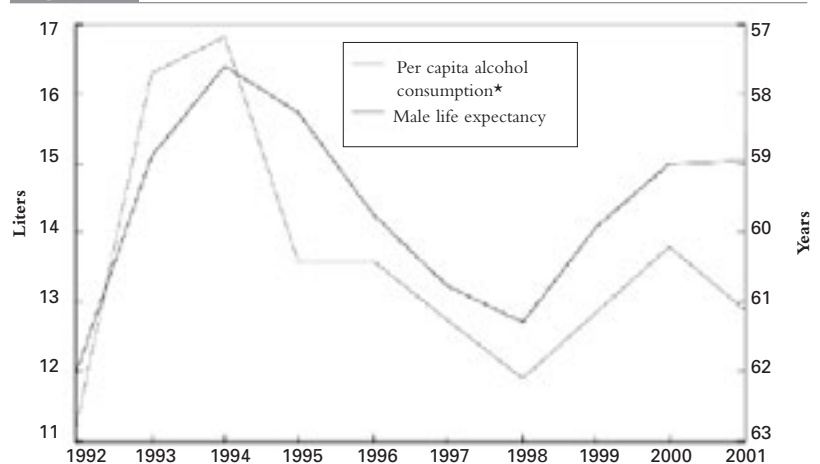


Figure 9.



*expressed in terms of 100% alcohol equivalents

(From Julie DaVanzo and Clifford Grammich, *Dire Demographics: Population Trends in the Russian Federation*. RAND, 2001 and updated estimates from Clifford Grammich)

That correspondence, however, might mislead. Figure 9 might seem to suggest that we could achieve immediate and sustained health progress in Russia today if only we could somehow reduce vodka consumption. Would that things were that simple! The unfortunate fact is, Russia’s mortality structure today is burdened by an enormous amount of what we might call “negative momentum.” The burden is so severe that it would actually be a neat trick for the current generation of Russians—including Russians in the country’s Far East—simply to re-attain the health levels that their mothers and their fathers “enjoyed” 30 or 35 years ago.

Figure 10. Male Mortality by Birth Cohort: Japan, ca. 1901–1985

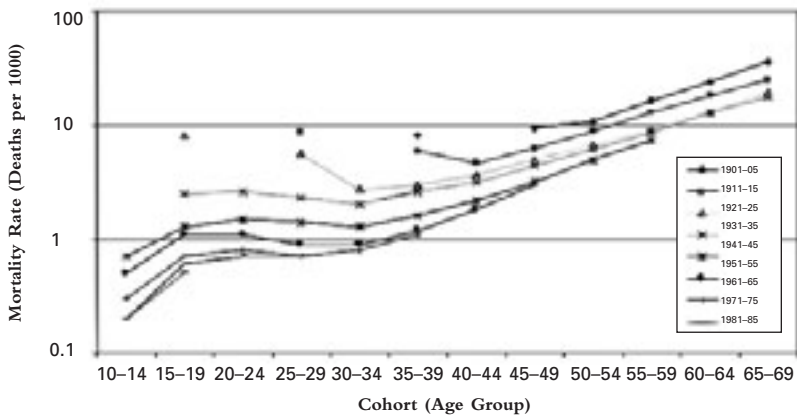
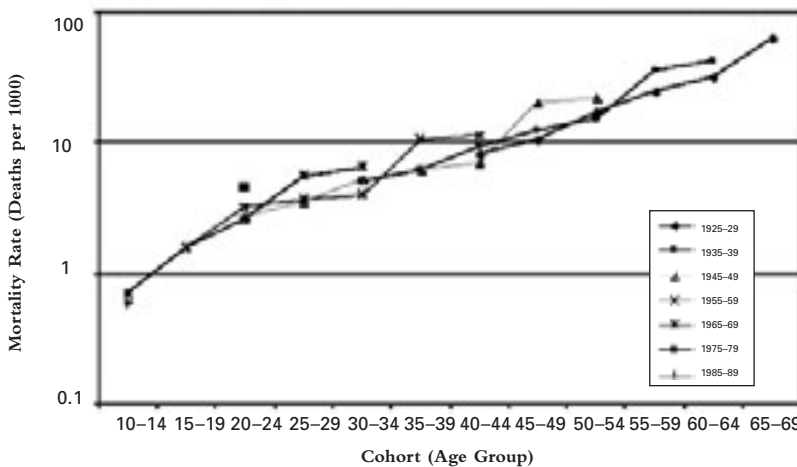


Figure 11. Male Mortality by Birth Cohort: Russia, ca. 1925–1989



One way to demonstrate why this may be the case is by a comparison with Japan. **(Figures 10. and 11.)** If we examine the post-war death rates for Japanese men from different birth years, we see that mortality schedules steadily and progressively improve with each new birth cohort. Among Japanese men in their early 40s, to take just one example, death rates were less than half as high for the cohort born in the early 1950s as they had been for the cohort born in the early 1920s.

By contrast, what we see in modern-day Russia is that the least healthy group, as measured by mortality levels, is almost always the most recent one. Among Russian men in their early 40s, for example, death rates were *higher*—indeed, over 40 percent higher—for men born in the late 1950s than they had been among their counterparts born thirty years earlier. The

same sort of problem obtains for other adult age groups, male and female alike.

In simple arithmetic terms, the gradual but prolonged deterioration of mortality conditions in modern Russia means that Russian men would have to achieve some significant improvements in survival prospects over the next ten or fifteen years *simply to achieve their father's health patterns*. But even if Russian men re-attained their fathers' survival schedules, life expectancy for adults would still be shockingly low. Data from the "Human Mortality Database" (maintained conjointly by the University of California at Berkeley and the Max Planck Demographic Institute in Rostock, Germany) and life tables from the World Health Organization make the point.

As of 1999, for Russian men in the 25–64 age group, re-attaining the survival schedules of 1970 would require an overall reduction in mortality levels of over 20 percent—no mean feat. But even if Russia were to accomplish this feat, the odds of a 20-year-old Russian man's surviving to 65 would only be about 60 percent. Just to put those odds in perspective: they would still be worse than the odds of a 25-year-old man making it to age 65 in India, Pakistan, or Bangladesh today.

By the same token: the survival schedule for adult women in Russia is not nearly as harsh and unforgiving as for adult men—but even so, decidedly fewer women would have made it from 20 to 65 on 1999 survival schedules than under mortality conditions that prevailed in Russia three decades earlier. To get back to 1970 survival schedules, age-specific death rates for Russian women would have to be cut by about 15 percent across the board—and even then, adult survival schedules for Russian women would barely be more favorable than the schedules for Turkish women today.

To make matters worse: Mortality levels in Russia today are higher—not lower—than they were in Russia five years ago, back in 1999. And mortality levels in the Russian Far East are dismally similar to mortality levels for Russia as a whole these days.

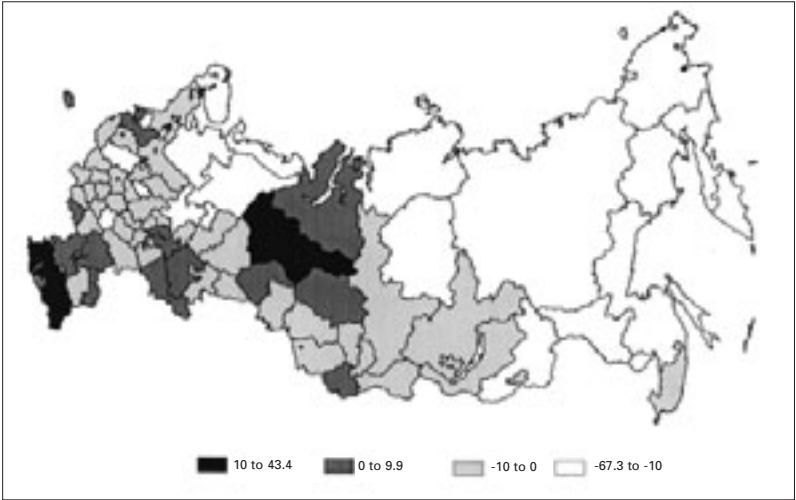
Despite the depopulation recorded for Russia overall between 1989 and 2002, some parts of the country have been registering population increase: most conspicuously, Moscow. **(Figure 12.)** Why, then, has the Russian Far

East suffered such a dramatic population decline in recent years? In arithmetic terms, the drop has been driven not so much by negative natural increase—although deaths have definitely exceeded births—as by massive net population out-migration. And why has that occurred? Here I commend to you, if you have not yet read it, Clifford Gaddy and Fiona Hill’s superb new book, *The Siberian Curse*. The authors argue persuasively that patterns of settlement in the Russian Far East have been profoundly unnatural: enforced historically by Tsarist *ukase* and Stalin-style “planning” (including Gulag development). With the attenuation of those profoundly unnatural policy forces, a voluntary exodus of population from this region naturally commenced—and may not yet be through.

We should note also that recent patterns of out-migration from the Russian Far East have not been not entirely random. The groups that moved out of the Russian Far East were disproportionately people of working age—and we may well conjecture that they were probably also disproportionately more educated, more motivated, and more entrepreneurial. If one wishes to match existing human resources from the Russian Far East to the development schemes we have been hearing about for the region today, this massive and differential out-migration constitutes a more than incidental problem.

In the Russian press today (and oftentimes in the foreign press as well) there is considerable speculation about foreign migration into the Russian Far East. I am sorry to say that I do not have much hard data to bring to the table here. In the Russian press and sometimes in Russian political circles, as we know, there is considerable discussion of the “yellow peril” variety regarding Chinese migration into the Russian Far East, and truly remarkable numbers tend to be bandied about quite credulously. Sometimes one hears about hundreds of thousands of Chinese immigrants in the Russian Far East; sometimes the talk is in the millions. I cannot find data to substantiate those sorts of claims. For what it is worth, the 2002 Russian Census counted roughly 30,000 Chinese nationals in Russia as a whole, and a smaller number in the Russian Far East. I am quite prepared to believe that that figure is too low, but it is quite a stretch to go from roughly 30,000 enumerated perma-

Figure 12. Intercensal Population Change, Jan. 12, 1989 to Oct. 9, 2002



nent Chinese residents to the hundreds of thousands so often imagined in contemporary discourse, much less millions.

Well, how does one deal with the demographic problems facing Russia these days? To date, we could describe most of the Russian Federation’s responses to the country’s population problems—crudely, but not altogether unfairly—as tinkering at the margin. There has been a certain limited official attempt to talk up the birth rate. Talk will do many things, but it will not increase national birth rates—in Russia or elsewhere. There has also been an apparent attempt to talk down the death rate, especially by the “Cheerleader in Chief,” exercise enthusiast President Putin. But, then again, tangible health policies will probably take us rather further than occasional comments about how the public needs to exercise more and drink less—and we are still waiting for those national policies.

Then there is the question of immigration policy, where, again, I think we are still talking about very tentative steps. The Russian government is just beginning to experiment with what we might call a French Foreign Legion or U.S. Army model, offering citizenship to foreign nationals who join the army and conduct a certain period of service. But certainly, here we are talking about hundreds or, at most, thousands of people, not hundreds of thousands of people. Such a limited and selective expansion of immigration is patently incapable of stemming the country’s prospective population decline.

From the demographic standpoint, the prospects of the Russian Far East bring to mind Clemenceau's early 20th Century epigram about Brazil: "It has a great future. It has always had a great future. It always will have a great future."

Thank you very much.

Discussion

PAUL RODZIANKO Four thoughts came to mind as I listened to this, and maybe we can make these a point of departure for the discussion. The magnitude of the long-term decisions that are needed have become evident in the course of this panel. But this morning we also heard about the short-term preoccupations of the area. How can we reconcile that divide? Then there is the issue of access to markets: does one go offshore or to the immediate neighbors? And what are the relative economic implications and opportunities of each? On top of that, there is a lot unknown regarding the resource base. Outside of Shawn's described fields, who knows what exists there and what implications that will have? And then there is building the infrastructure that will be needed if this area is to develop. What political and social model will be used for building and developing the needed infrastructure? With that, let us open the floor for questions.

Q. *We heard about China's interest in securing access to energy supplies in Russia, Central Asia, and in the Caspian. I am puzzled. Why has China not sought to invest in the Sakhalin projects? And this is related to another part of my question. Is there perhaps some overestimation of China's demand for gas? Because both the Kovykta and the Sakhalin projects seem to be focusing heavily on the Chinese market.*

Q. *This is related to the previous question. Mr. McCormick earlier referred to a window of opportunity closing in a number of years for China if they wish to switch over to natural gas—that is, China would take a decision around 2008 about switching over to LNG. I am just wondering, what makes one think that China would go off coal? I mean, we all hope that China will go off coal, but we would have hoped for this to happen a lot earlier. It still has incredible coal reserves, and it seems quite likely to me that, depending on price and so on, China could continue to rely on coal for a lot of its energy needs.*

Q. *Marshall referred to the problem with Turkey, and what it did concerning the Blue Stream pipeline. But that was in considerable measure because the Turks had greatly overcommitted themselves contractually to sources of gas from Russia and from other sources, and then the Turkish economy tanked. I am wondering whether or not that potential analogy could also apply in the case of China. China is contracting energy resources from a vast variety of places. They are even involved in oil exploration in Georgia. And while everyone draws straight-line extrapolations of the Chinese economy, my first macroeconomic theory professor's first law of economics is that straight-line extrapolations are always wrong. I am wondering if the Chinese will contract for so much that at least somebody is going to have to take a hit, if in fact the Chinese economy does not develop in quite the dramatic way in the future that is sometimes projected.*

Q. *I have a question to Shawn McCormick. On what terms do you expect Gazprom to participate in Kovykta? Because without Gazprom, basically you cannot go forward. Thank you.*

Q. *I would like to add a question to Professor Bradshaw about the possible participation of Gazprom in Sakhalin-2 project.*

MICHAEL BRADSHAW Thanks. Regarding why China is not involved in the Sakhalin project, I think it is quite instructive to think back to the situation in 2001–02, concerning Phase 2 of the Sakhalin–2 project. Much of the discussion at the time was about the logic behind the LNG options. At that time, most people seemed to be saying there was no market for LNG in Northeast Asia, and that there would not be any market anytime soon that Sakhalin could access.

You have to wonder why, in 2001–02, Shell would be so anxious to find a new project. And I think there may be answers to that, which have been revealed of late. But the thing that impacted Sakhalin–2 in part was problems in the Japanese nuclear industry. It created a small market opportunity to provide a modest amount of supply to Japan because they were reconfiguring their estimates. I think it was in November of 2002 when the commercial manager for Sakhalin Energy came to the London Sakhalin Gas Conference and said unequivocally, "In 60 days we will have a contract with a

major Japanese utility company to supply LNG.” And that completely caught everyone by surprise. In the following May, they signed off on Phase 2. So, it is not driven by China. In the case of Sakhalin-2, there are two Japanese groups whose primary role is to deliver about a third of the supply that is intended for the Japanese market.

In the last couple of months, there have been very positive statements made by Chinese spokespeople as a consequence of visits to the island, or most recently when the Governor of Sakhalin went to China. These statements described the positive benefits of the Sakhalin projects, how Sakhalin LNG was an obvious source of energy for China, how China should get involved, and how a third LNG plant should be built on the coastal regions to take LNG from Sakhalin.

So, there is a lot of talk. It may be that equity involvement in Sakhalin-2 comes as part of the deal, because Shell has a large holding and could find room to offload some of that holding. So that might be something that is about to happen. Who knows? Maybe another third of the Sakhalin-2 production could go to China. Sakhalin was not in the frame then because they had not committed to build the LNG terminal. It is very difficult to sell a project when you have not actually committed to build the project. Now they have committed to building it, and they are building it. The other third would likely go to South Korea, they hope, or the U.S. West Coast.

But there is also a role for Sakhalin to supply short-term contracts into Northeast Asia, because one of the benefits of the LNG project in Sakhalin is peak production in winter. That means that the consumers do not have to store as much LNG if they can take delivery, because Sakhalin is relatively close. The other benefit, of course, is that you are producing in a cold climate, as opposed to the Middle East, Indonesia, or Northern Australia, which makes LNG production cheaper, or so Shell says. There are competitive advantages to the Sakhalin LNG project. And as the LNG market globalizes, and as more short-term contracts and a kind of stock market develop, then you could find Sakhalin having key customers—Japan, China, South Korea—with production available to fill short-term contracts.

With the heightened China talk, they are even talking about building a third LNG supply train. And that does seem overly optimistic. So, perhaps we are overcooking the China market. It is part of the equation; it is not the only solution.

Regarding Gazprom and Sakhalin-2. I am sure if we had a representative from Shell or Sakhalin Energy, he would simply say, “Well, we are in constant discussion with Gazprom about equity involvement in Sakhalin-2.” But, what does Gazprom bring to the table for Sakhalin Energy now? Sakhalin Energy does not need the political support that Gazprom might bring. It has approval to build the pipelines and infrastructure. Five years ago, Gazprom would have made a difference. In a sense, Sakhalin Energy has more to offer Gazprom, because Gazprom has no experience with LNG, and Gazprom has no experience with the Northeast Asian market, particularly when it comes to LNG. It is sort of ironic, really, that Gazprom’s role, if you believe the Russian energy strategy, is to coordinate Russia’s gas exports to Northeast Asia. Here’s a quasi-state-owned company that has no resources and no pipelines at present to access those markets. So the only way it can start to deliver is to leverage itself into the existing projects.

I would suggest that perhaps the leverage is much greater for Kovykta—but I will leave it to TNK-BP to answer that question—than it is for Sakhalin Energy because of where Sakhalin Energy is with its project. However, Shell may have other cakes to bake elsewhere in Russia. That means that there are advantages to bringing in Gazprom, in terms of what it will do in terms of their other plans elsewhere in Russia. Of course, they already have a relationship with Gazprom. So Gazprom’s involvement may not be necessary for Sakhalin-2, but it is involvement might be necessary for a future relationship for Shell and Gazprom elsewhere in Russia.

SHAWN MCCORMICK The questions about overestimation of Chinese demand, and why we think the Chinese are going off coal, were somewhat linked. First, the reason why we think the Chinese are going off coal is that they have said it. They have laid it out as part of the government policy over the last several years that this is their intention and desire as to

where they want to go, and they are going to put it into practice. They are putting it into practice by saying where they are going to get their energy sources from in the future and by moving down the path towards LNG. We have seen it in the construction of LNG facilities in Southern China as part of that process. And now they are continuing that trend up into the north and northeast of the country over the next couple of years. It is not us wishing for it. It is them saying what they will do, and we are following up on that.

In terms of overestimating the market, those are good questions. I was speaking recently with someone in the U.S. government who said that in the late 1980s they did some long-range projections on gas demand, and that, looking back, the one thing they got wrong was Chinese energy demand overall. They radically underestimated what it would be in terms of growth of the economy. We heard some comments earlier about Chinese exporting oil in recent years, and now it is the world's second largest importer.

We have gone to the marketplace and seen what the energy demand is. We are not taking other people's word for it. We have gone on the ground, spent many, many man-years of effort compiling studies about the marketplace itself in North and Northeast China to understand the potential consumers and what they see as their potential needs. We have integrated this with a whole series of other data from different places to get an understanding of the market and what could happen. So, it is not other people's word. We have actually done our homework on the ground, and we are not letting other people do the work for us in that regard.

For any of us who have been to Beijing, and I think some of our colleagues have been there very recently, the impact of burning coal is very evident, and the Chinese want to get away from that. Gas is cleaner. It is a more efficient energy source. And regarding pipeline gas specifically, we beat LNG and we are extremely competitive against coal. So it fits into where the Chinese are going overall.

On the other question about who's going to take the hit if China contracts for too much? Well, I think we have the volumes. We beat LNG. So, good luck to the others. We like competition.

About terms of gas participation: This goes straight to the heart of things. I will give you a snapshot of where it stands now. We could do this project. We could get it up and running. We could do it just about anywhere in the world. In Russia, there are realities. As I said, there are the economics and there are the politics. The politics are one of the issues we are facing. We understand the realities of Russia. We do not force our view of politics on them. That is part of the reason I think BP has been successful in Russia. It works to understand Russia, and we have worked with Russia to come up with win-win solutions, as opposed to saying "you take it our way, or we will get mad and call Washington to thump you over the head, and then we will all be mad." So it is a different approach, fundamentally. Therefore, on the issue of Kovykta gas, we have a strong view that if this is going to work, it is going to work with Gazprom.

I think the right answer, as far as going forward on this project, is something that is going to involve both fields in a phased-development nature. The routing of the pipeline that I showed you was one that is based on the international feasibility study from 2003. We will see how that ends up going forward. There are options there. I think the most important thing, as far as potential customers are concerned, is who is going to market the gas. And we are having very active negotiations with Gazprom and have had very good progress over the last several months on that front. So there is everything to play for. We have got a couple of months to go until this window closes, and we are increasingly confident that we are approaching this thing in the right fashion.

Gazprom has made clear that they want to do more than just market the gas. They have another field near Kovykta. There are three shareholders in receipt of the petroleum: ourselves, with 62-odd percent, the local authority, and another private sector company. That private company and the local authorities have said they want to sell out. Gazprom has said various things about it. But I think it needs to be seen in a holistic package and I think Gazprom's participation would clearly be at a much more significant level than we see before us today. So this is all up for negotiation. But I think you will see—if this works, there will be a single face to the market and there will be a significant role with Gazprom.

MARSHALL GOLDMAN Is Turkey a good analogy? I do not think it matters that much about the quantity and other sources of supply. I think this was just a question of “my God, we got ourselves caught there,” whether or not Turkey had contracted for too much or additional sources of supply. I mean, from the point of view of Gazprom, they built that pipeline and they are stuck with it. They have costs that are attached to it. And the moral of the story would be: Do not build a pipeline where there is only one potential customer. I think that is the main thing.

Let me just add one other comment about some of the other questions. I think the important thing to keep in mind is that, at this point, China’s energy consumption is only ten percent on a per capita basis of that of the United States. And, you know, given the fact that their population is six or seven times that of the United States, there is a lot of potential growth in demand out there that can affect us all.

Q. *I would like to know what are some of the advantages and disadvantages having a joint effort to develop as well as distribute the resources among those countries in the area? In other words, how do you consolidate the market, as well as distribution, in the area on whole instead of having bilateral or individual agreements? Would a multilateral agreement be more feasible or more advantageous? What are the disadvantages following that particular approach? Thank you.*

Q. *Regarding China’s growing demand for energy resources, we have seen that China is also interested in getting oil and gas from the Central Asian countries. China has investments in the energy sector in Kazakhstan and also Uzbekistan, and it has been interested in laying pipeline for the last several years. So there have been investments made by China in the Central Asian countries. Yet even as China is investing in Kazakhstan, Russia is also interested in controlling Kazakh oil going to China. On the other hand, the Shanghai Cooperation Organization has been operating with Russia, China, and Central Asian countries as members. So there is regional cooperation also. Will there be some sort of conflict of interest in controlling the oil and gas of Central Asia between Russia and China? The same question goes for pipeline policy—Russia is interested in controlling the oil that is going from Central Asia, from both Uzbekistan and Kazakhstan, to the east. What is*

your opinion, is more cooperation likely, or do you think more conflict is likely between these countries?

Q. *I wanted to go back to the question about the magnitude of decisions and talk about the time factor. We had presentations describing the thirty-year projects on Sakhalin and all the regulations, approvals, and licenses, and so forth. At the same time, Shawn talked about a very short timeline for decisions. I was not quite sure at what speed he expected to be up and producing and delivering, but it sounded like those timeframes were not meshing too well. And given the magnitude of these decisions and the complexities, I can appreciate that for a bilateral deal the timeframe may be shorter. But I would be interested in also relating to the prior question about cooperation, because thirty years ago Japan was sort of leading the pack in trying to come up with cooperative approaches to energy, including Siberia and other sources. Now it does not seem as if Japan is leading the pack, it is more the major oil companies offering options. And so I would be curious as how you saw the Japanese role in these projects for the future. Thank you.*

Q. *I have a question for Shawn in terms of financing the pipeline. If you are talking about an \$18 billion pipeline, think about trying to put the financing together in this timeframe, especially if you take how long it took to finance Baku-Tbilisi-Ceyhan (BTC) pipeline as an example. Granted, this one is not as complex politically once you get the two players involved. But given BP’s commitment to following the World Bank guidelines for assessments and such, how does the financing come into play in terms of meeting the timeline?*

MICHAEL BRADSHAW The first question was about multilateralism. I have lost count of the numbers of conferences, papers, and other efforts there have been about multilateral cooperation on energy in Northeast Asia. I have been to at least three or four, and there is often talk about creating an energy charter in Northeast Asia, somewhat like the European Energy Charter. The problem is that there is no track record of multilateralism in the region, and we will hear more about this tomorrow. There is more of a history of conflict than of cooperation. And you see it rewritten again with the pipeline to Japan versus China.

If you go to South Korea and talk about Russian pipeline gas, they have strong feelings

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because there is an intervening opportunity. Whatever route you go, whether through China, Russia, or North Korea, for South Korea a pipeline has to be multilateral just to get there. I would like to say that it is the obvious thing to do. Many have even spent a lifetime trying to convince people that it is the obvious thing to do. But I think the real politik at the moment is not about cooperation, it is about competition. There is a great deal of talk about multilateralism, and the irony is that, yes, it is probably needed. But my view is that it will eventually come through bilateral agreements. I think trying to go for a multilateral agreement as the means to solve the logjam is not politically realistic.

The time factor, long-term versus short-term, was mentioned. I do not think that the Sakhalin-1 and -2 projects are the real test. Yes, they have taken thirty years, and that is a kind of wake-up call. They have that history and, in a sense, that is why they were able to work in the 1990s. The real test will be BP's Sakhalin-5 field and Kovykta. Then we will get a sense of how long it *really* takes to develop entirely new projects through an exploration phase to development. Sakhalin-1 and -2 are not evidence that you can make projects work in Russia from scratch, because that is not what they are. They are quite different.

Regarding the role of Japan. One of the ironies about those compensation agreements I mentioned was: What did Japan provide? It provided the finance. Where did the technology come from? When the United States slapped sanctions against Soviet imports of U.S. technology in 1979 to protest the invasion of Afghanistan, one of the casualties was the Sakhalin project, because the technologies being used to carry out the seismic surveys were U.S.-licensed.

Now the much bigger issue is about control over technology. When I talked about 3-D seismic surveys and horizontal drilling, clearly one of the things that BP brings to the table for TNK is technology. I think Japan's role remains finance and market. I mean, that is the role you see them playing, not the technology. It is not necessarily an area where they are particularly strong. The offshore export is easy, and you will see European companies sitting there salivating. They see that as their backyard. So, I will leave it at that.

MARSHALL GOLDMAN I think the Chinese are going to be very interested in doing whatever they can to encourage development in Central Asia. I think the important thing to understand, though, in the whole question of the rebirth of Southeast Asia is that there is now enormous energy demand, and those who have the oil are going to be much more selective in the way they behave. The illustration of this is what happened with Sakhalin-3 when the Russians simply said, "Okay, your tender is no good." I think that is going to be important for the Central Asians, who can ask for a higher price, and also for the Russians, who will begin to ask for a higher price on almost everything that is being done.

SHAWN MCCORMICK Let me try and wrap together a couple of the questions about cooperation versus conflict, and multilateral versus bilateral agreements. In our view, what drives this is the resource, and then the market. This is not politics looking for a resource. This is a resource looking for a market and the realization of politics. There is a lot of talk about an oil pipeline through this region. But no one can sit here and tell you where the oil resource is to go into the pipeline. What we have done is nearly a decade's worth of work and spent in excess of \$800 million understanding the resource first, then the marketplace. We have worked with potential customers on a solution, which is how we got that international feasibility study of about eleven volumes and 5,000 pages on that pipeline that I discussed.

So I am not coming to you to say, "We have a license, and we think there is a lot of gas there, and we would like to do something." What you are seeing is the end game where we have to make a decision, because the Chinese and the South Koreans have said that they have to make their own decisions on what energy they want in order to get gas in 2008-09 for China, and 2010-12 for South Korea. The investments have to go in many, many years in advance. They have to make their own decisions, which is why we have been working for ten years to prove up the reserves; come up with a package; get together with entities in those countries to develop an international feasibility study; and push for the negotiations on price, structure, and mechanisms. So that is what you are seeing

here. It is a wish, but it is a pretty well informed wish with a tremendous amount of work that has gone behind it across different borders and for quite a period of time. It is the energy and the resource that is driving us, and then we look at the markets.

About the issue of the timing, I just want to reiterate that the Chinese market window is for 2008 to 2010, and they want to sign a contract for that. It is LNG or us. It takes time to build and develop the resource somewhere else, like Tanggu, for example, or in Indonesia, the North West Shelf, Australia, or Qatar. Sakhalin also takes a long time—to build a pipeline, lay it, and get it to that point takes many years. So there are some fantastic commercial brains and finance people who game all this out and then work back to where we are and come up with these schedules.

There is a huge amount of competition going on, and the governments involved—Indonesia, the United States, Australia—are all over the place and are involved in this game. The Chinese and the South Koreans are sitting in the middle and saying, “Who’s got the best price? Who’s more dependable? Who can we count on? What gives us greatest equity as we look forward?” They are in the driver’s seat and they have got options before them. I spent more than a decade of my life in Africa. There are lots of resources, but no customers in Africa. It was all somewhere else. Here we have got the two in relative propinquity, which presents the customer with some good competition, and we like that.

Another questioner mentioned a point about BP environmental standards. We are not BP. We are TNK-BP—it is a separate company. We operate on different guidelines, just as a sub-note to that point.

The financing is a big issue. You are right; it is a very serious thing. There is a comprehensive effort that is underway looking at what might be possible. We are trying to get more data and pull on this. We do not know who the partners are going to be yet, and what the partners could bring to the table. So an awful lot of work is going into various areas, of which financing is a piece. We probably need more people working on all aspects of this thing. But as we get closer to the deadlines and there is more energy pulling it forward, there will be more resources dedicated.

There is a lot of additional work that needs to go into these projects, and it takes a huge amount of time. We spend billions up front, and you wait a decade or two to get money back and make any profit. So there is a lot of work that goes into it, and there is more work on this front that needs to go into it as well.

Q. I wanted to bring Nick into this discussion. The panelists are talking about billion-dollar projects in Siberia and Sakhalin, and pipelines going across thousands of miles. Given the hollowing-out of the working-age population in these regions, is there a population there to build these pipelines, and not only build them, but to provide the supporting enterprises that go along with these sorts of projects? And, if not, are there plans to get around this obstacle on the part of the companies?

Q. Also a question for Nick. Are there any historical examples or models for a country overcoming that kind of tremendous negative drag that Russia is carrying into the near- and mid-term future in terms of its demographics? And a second question: The numbers that you were putting in front of us were looking about 10, 15, 25, years out. As you know, three years ago, Goskomstat came out with those startling projections with a few variants—optimistic, pessimistic, and median. Looking out 50 years into the future, the projections ranged from 126 million as the most optimistic estimate, 100 million as the median, and down to 77 million as the most pessimistic estimate for the total Russian population. What is your best guess as to what the total Russian population looks like 50 years out into the future?

NICHOLAS EBERSTADT The paradox of population prognostications is that projecting a couple of years into the future yields results that are fairly accurate, but utterly uninteresting. By the time the results get fairly interesting, they are often rather inaccurate. Population projections for 2050 are in the science fiction domain; there is not now, nor will there ever be, an exact scientific method for establishing how many babies the unborn will have.

If Russia continues to be characterized by poor health conditions and a sub-replacement birth rate, it would not be unbelievable to think about every next generation in Russia shrinking in size by a third or even by forty percent. That could easily mean that in fifty years the Russian

population would be barely half as large as it is today. However, no dependable prediction on the size of Russian population can be made at this time, since additional factors, such as migration or increases in birth rates, could significantly alter Russia's demographic landscape. Nevertheless, at present it is hard to imagine how Russia's population two generations henceforth would be as big as it is today, unless large numbers of new people move into the country.

As far as historical precedents for the current Russian experience are concerned, there are none—we are in *terra incognita*. Co-sufferers in more-or-less similar circumstances today, like Ukraine, could provide some grounds for comparison. However, Russia's demographic travails today are still an ongoing experiment, and no dependable conclusions could be made before the final results come in.

As for skilled manpower requirements—I regret to say, these are outside my field of expertise. I do not know how many people would be necessary to operate the pipelines in the Russian Far East. Shawn McCormick and Michael Bradshaw would be more qualified to speak on that issue. However, in the final analysis, it may not be the number of people, but the skills necessary to operate those enclaves that matter. That is not to say that the manpower with the requisite skills for these projects is already located within the region.

MICHAEL BRADSHAW This question has been taxing the Sakhalin operators because they are now in the construction phase. I think about 6,000 workers are being employed on the island at present between the two projects. They have had a real problem finding those workers. This is not just directly in the individual projects, because there is other activity on the island soaking up workers for construction and so forth. So they have been searching high and wide. In fact, at one point, ExxonMobil was asking about doing an analysis of the population of the Russian Far East to find where else they could look, because the engineering industry on the mainland is involved in the projects. But much of the out-migration in the 1990s was the skilled population, which is a familiar story.

The thing to remember is that this labor demand is during the construction phase. Once the construction phase is over and you are run-

ning the projects, you might have between 500 and 1,000 people involved in running the actual operation. There is this phase when you need to bring in workers, and you need work camps. You have to plan the work camps carefully. You have to think about the social impact of the work camps, and they are going through that now. But, by 2005, they may have all gone home, which means if BP comes along and needs the workers, they will have the same problem.

The bigger question, I think, particularly in the Russian Far East, is what happens if the population does go below five million? Does it matter? This is a shameless plug for an ongoing project I am involved in at the moment, which is looking at the effect of occupation of Russia's national territory. One of the things we are doing is mapping the census results at a fairly detailed level. The answer is yes and no—it depends where the population is. I think one thing that became evident, hopefully through discussions this morning, is that really there are three regions that count at the moment—Khabarovsk, Primorsky krai, and Sakhalin—the southern core of the Far East economy. And that is the area that has experienced less of a demographic downturn. And then there are outliers, like Sakha and so forth.

But the big declines are in the north. And if you follow the Hill-Gaddy thesis, that is going to happen anyway. The problem there is the people who are left behind for whom it is home. They become a welfare problem, and they *really* are a problem. But they are a problem which we are familiar with in terms of situations in Alaska, perhaps, but certainly in Northern Canada. So the population could be less than five million. And there is some interesting work Vlad Kontorovich is doing on this: Can Russia resettle the Russian Far East? His answer, I suppose, is “no, and they should not try and it does not matter, because you can replace labor with capital and technology, particularly in these resource sectors.”

Someone asked me earlier why I study Russia, and I have what I call my “*Star Trek* moment.” Every trip, I feel like, “Beam me up, Scotty. I do not want to be here.” And then I always wonder, “Well, why did I not study the Caribbean?” If you are going to choose an island, why Sakhalin? But there are some very interesting issues here in terms of the relation-

ship between development and settlement. And the reason that we get hung up on the numbers is that the Soviet experience of developing the Russian Far East, “development” equated to “settlement.” And that is why you have the population that you had. But that is no longer the case. Some of the ideas Gaddy and Hill discuss in their book—and they quite nicely footnote me—touch on this notion of “a leaner, cleaner future.” That is, you can have fewer people, more economic output, and a lower environmental footprint—you could become a Western Canada or a Pacific Northwest. I started my research on these issues from the campus of the University of British Columbia, which is somewhat different from Sakhalin State University.

I think one should not get too hung up on the numbers. The problem is the mindset in Moscow is such that the numbers *do* matter. That is the issue. It is about perception of threat. I think one of the key issues, of course, is getting the immigration policy right. There is a role to be played, and historically there was a role, for the Chinese community in the region. There is a role to be played again.

It is not all doom and gloom in that sense. But the southern part of the Russian Far East is, to my mind at least, what really matters. I can see a model of a leaner, cleaner, greener Russian Far East, where there are fewer people, but they are better off. But that is fifty years from now. Maybe it is twenty years from now. Otherwise, I think we will leave the room being terribly pessimistic about what is going to happen. It does not have to be a continuation of the past. The underlying forces that created the Soviet Far East do not exist anymore.

Concluding Speaker— Jeffrey Miller

JEFFREY MILLER Distinguished speakers, guests, I am delighted to be part of this conference. I want to talk to you today about a recurring theme that I saw in today’s speeches and panels. Trade will play a key role in integrating Russia fully into the community of stable free-market economies, and, of course, energy is a huge component of this potential trade.

The West, particularly the United States, wants to diversify energy sources from the Middle East to other stable regions, and

Northeast Asia already is a critical component in this diversification. But huge investments will be needed to further expand and modernize Russia’s energy sector. Private financing cannot do it alone, nor can public funds. It will take a cooperative effort by organizations like export credit agencies, such as Ex-Im Bank, and international financial institutions, otherwise known as multilateral development banks, including global and regional development banks and private lenders. We must all work together to make this happen for the benefit of Russia and all its trading partners. As I mentioned, enormous investments will be required to help Russian companies access goods and services that are needed for them to grow. The potential for trading partners to supply technology, capital, equipment, and services is great.

It appears that Russia may be on the right track. Accumulative foreign investment in Russia increased by 50 percent in 2003 from the previous year. Russia’s trade surplus last year was \$60 billion, up from \$46 billion the year before. Russian exports to the United States rose 26 percent in 2003 to \$8.6 billion, while U.S. exports to Russia increased only 2.2 percent to \$2.45 billion. Russia’s exports to Asia, meanwhile, jumped from \$11 billion in 1999 to \$19 billion in 2002. In addition, Russia’s trade is likely to be enhanced by the fact that the OECD upgraded Russia last year from risk category 5 to 4. This upgrade has lowered the minimum premium for Russian transactions charged by export credit agencies and is a very big indicator of increased confidence in the Russian economy.

The energy sector, in particular, represents a unique opportunity. I am sure you have heard a lot about this today, but let me just go over a couple things. In order for Russia to expand its trade relations with the world’s industrialized nations, it will take a unique opportunity and needs big investment.

Let’s talk about natural gas. Many are familiar with Russia’s huge oil reserves, and Ex-Im Bank has financed the export of more than a billion dollars worth of U.S. goods and services, and equipment, to help modernize and develop Russia’s upstream and downstream capabilities to date. But in addition to its oil sector, Russia has been blessed with more than 25 percent of the world’s natural gas reserves,

Russia has been blessed with more than 25 percent of the world’s natural gas reserves, an estimated 1,700 trillion cubic feet.

an estimated 1,700 trillion cubic feet. This represents almost twice the reserves of Iran, the country with the next largest reserves, at over 900 trillion cubic feet. It is estimated that consumption of natural gas, which is a more environmentally friendly fuel, will grow at an average annual rate of 1.8 percent during the next 20 years, with the greatest increase projected for the North American market. In industrialized Asia, natural gas consumption over the same period is expected to grow 1.8 percent annually to 6 trillion cubic feet by 2025. In developing Asia, consumption is expected to grow from 7 trillion cubic feet in 2001 to 17 trillion cubic feet in 2025. This increase in natural gas consumption will require new gas resources to market either by pipeline across land routes, or liquefied if transported by sea.

At present, North America produces nearly as much natural gas as it consumes. It is anticipated that this will soon change. Within six years, it is expected that North America's consumption will exceed production by nearly 2 trillion cubic feet, or nearly 8 percent of the total current consumption. This gap, in the absence of any new discoveries, is expected to widen to 5 trillion cubic feet in 2020 and 6 trillion cubic feet in 2025. For North America at least, it is clear that trade will be essential in meeting this shortfall. The challenge, therefore, will be to develop the necessary infrastructure to transport such resources to world markets. For our part, since the mid-1990s, Ex-Im Bank has supported \$2.8 billion in projects involving natural gas exploration, pipelines, and LNG facilities, as well as projects fueled by natural gas around the world.

As I mentioned earlier, Ex-Im Bank has been active in developing Russia's oil and gas industry. Almost 50 percent of our portfolio that we have in Russia is in this area. We have helped support modernization efforts of more than a dozen oil companies with medium- and long-term financing, and we are looking at several pipeline projects that would help bring Russia oil and gas to market. Ex-Im Bank is prepared to work with sponsors to develop projects that are well structured, technically feasible, environmentally friendly, and have a well-balanced risk profile. Ex-Im Bank prides itself on its expertise in this sector.

Let me give you an example. Ex-Im Bank acted as a major financier in developing Middle

Eastern gas resources during the mid-1990s, thus the development of Qatar's gas field may illustrate Ex-Im Bank's potential role in Russia. Qatar is a relatively new supplier to the LNG market, sending its first shipment to Japan in 1997. In the mid-1990s, Qatar decided to commit resources to develop its huge gas reserves, ranked third in the world behind Russia and Iran. The country partnered with international companies with expertise in global networks, including ExxonMobil, Mitsui, and Marubeni.

Two main projects were developed for Qatargas and Ras Laffan. Qatargas has developed a long-term contract with key Japanese companies, such as Chubu Electric Company. RasGas established a long-term relationship with Korea Gas. These long-term contracts created the financial creditworthiness that attracted public- and private-sector financiers who provided the needed capital to complete these projects. Today, Qatar is a major player in the world's LNG market.

Now let me turn back to Russia. Certainly, Sakhalin-2 can be a similar project that will transform Russia, as Ras Laffan and Qatargas transformed Qatar. Sponsored by Shell, Mitsubishi, and Mitsui, Sakhalin-2 involved the development of the first liquefied natural gas project in the Russian Federation. The project contemplates construction of an offshore extraction rig, onshore pipeline, and a two-train terminal to be built on the southern tip of the island. The Sakhalin-2 project is expected to have a capacity of 9.6 billion tons per year. It is projected to begin shipments by 2007 or 2008. A major component of the project will be long-term off-take contracts with several Japanese utilities that will be secured by Ex-Im Bank and other senior lenders.

In addition to our fairly rigorous credit standards, the project must meet strict environmental standards. Ex-Im Bank, which takes its pride in its environmental stewardship, is proud of the fact that in 1995 it became the world's first export credit agency to adopt environmental guidelines for projects that we finance. Our environmental guidelines, which have been revised and extended several times, and just as recently as two weeks ago, require that the bank make quantitative and qualitative assessments of projects in terms of their potential impact on a variety of environmental criteria. Sakhalin-2 would be no exception. In fact, we are doing

that today. While this project is clearly important for U.S. exporters who will supply equipment, services, it will also demonstrate how well a structured, creditworthy project can facilitate regional trade and bridge the gap between Russia's natural resources and its ability to serve the marketplace.

Ex-Im Bank's support for Sakhalin-2 will not only finance exports, but also start cross-border connections and ties among the nations of the North Pacific Rim. Pipeline projects clearly can foster improved regional relations, as the example of the Baku-Tbilisi-Ceyhan Pipeline project demonstrates. This nearly 1,100-mile pipeline, with a capacity of one million barrels per day, will transport crude oil from Sangachal Terminal in Azerbaijan, through Georgia, to a marine export terminal in Turkey on the Mediterranean. Ex-Im Bank is working with six other export credit agencies, as well as a number of international financial institutions and private lenders to finance this \$3.4 billion project.

Another way in which Ex-Im Bank's efforts can help enhance regional relations is through the financing agreement with Vneshtorgbank (Russia) that we signed with President Putin last fall. This agreement paves the way for cooperation between the Ex-Im Bank and Vneshtorgbank in providing medium- and long-term financing for projects in third countries for using U.S. and Russian goods and services.

Despite the enormous potential of Russia's energy sector, Russia must diversify its economy in order to sustain long-term growth. Commodities, such as oil and natural gas, metals and timber, account for 80 percent of Russian exports and leave the Russian economy particularly vulnerable to fluctuating world commodity prices. Ex-Im Bank continues to support investments in Russia infrastructure projects—housing, optics, medical equipment, farm machinery, and other sectors that will benefit the Russian economy in the long term. In addition, Ex-Im Bank has strengthened its ties with a number of Russian financial institutions to help Russian buyers acquire more U.S. goods and service. We also have a number of credit lines—big and small—with various Russian banks. These total nearly \$200 million and are for the purpose of financing U.S. exports that will be useful to Russian companies.

Obviously, there are still some issues that Russia must address. Recent events at YUKOS and Sakhalin-3 have raised concerns about the weak rule of law and the potential for corruption. Western investors, exporters, commercial lenders, and export credit agencies need to be able to work with a government that applies policies and laws consistently and fairly. While Russia has made significant progress with reforms, it still needs increased transparency, better corporate governance, and a more open business environment to attract continued investment. Already-enacted reforms need to be more effectively implemented, and Russia needs to move further along the path of reform, which brings me to my final point.

While there has been substantial foreign investment in Russian energy and other sectors, more investment is needed to sustain this development. We need to work together with other export credit agencies, private banks, and international financial institutions—both multilateral and bilateral. We need to expand our co-financing initiatives with other export credit agencies and multilateral development banks. This gives both countries involved the leverage to win export opportunities that might not have been available to companies of either country alone. And as I have suggested, we must be sure that the environment must be protected in developing Russia's infrastructure—that is a very important point.

To sum up, it is important that Russia succeeds economically in this interdependent world. Trade is crucial to Russia's successes. Russia is a strategic market for investors and exporters worldwide, a vital source of energy, and an enormous market for a wide range of products. Given its history and its size, it is a key member of the world community. President Putin said that he wants the Russian economy to double in size in just ten years, which implies seven percent annual average growth. This is a tall order. It can be done. Ex-Im Bank wants to be part of it. I think all the other export credit agencies and multilateral banks would also like to be part of it. To realize this goal, during the next fifteen years, Russia will need to undertake a massive modernization of its economy and its infrastructure, including the important energy sector. This growth will require huge investments, as well as technology,

Despite the enormous potential of Russia's energy sector, Russia must diversify its economy in order to sustain long-term growth.

capital equipment, and services provided by all the industrial countries. It will take an open, transparent business environment governed by rule of law, and cooperation among a wide range of public and private financial institutions, including export credit agencies, such as the Ex-Im Bank, to achieve this.

BLAIR RUBLE Are there any questions or final comments?

Q. *In light of the uncertainty about property rights that has been raised in the last couple of days in Russia, could you comment broadly about the types of guarantees you take when you finance operations in that country?*

JEFFREY MILLER Well, we do corporate risk in Russia. We will look at the financial statements. We have a due diligence process. And we do a lot of our analysis based on cash flows, certain profit trends, and certain forecasting. We take into consideration, but we do not focus totally, on the property. We will look at a variety of financial indicators of creditworthiness that are established. And we are trying to get ourselves somewhat comfortable with Russian accounting standards, and how it correlates with international accounting standards.

Q. *There is no major U.S. investor in the Sakhalin-2 project. Does that pose a constraint for Ex-Im Bank financing for Phase 2 of Sakhalin-2?*

JEFFREY MILLER We are in Phase 2 from Sakhalin because there will be goods and services procured. It does not have to be a U.S. company. I did not give much of an introduction, so let me take 30 seconds. We promote goods and services from the United States. Our money is tied to that. We are not into projects or investments. We look at the pure financing of goods and services. And so there will be certain goods and services procured, probably from Shell or from some of the other investors. To the extent that there are U.S. goods and services, we will fill that financing gap in addition to the other export credit agencies. Obviously, Japan has a very large share of this transaction, but we are looking at a sizeable portion. The Japanese want us to be partners with them in this. To the extent that we maximize U.S. exports, there usually is

in these types of transactions equity in addition to goods and services. That is the debt piece, and we will take a piece of that debt. But as long as there are U.S. goods and services, we are in the game. It is a nice thing about Ex-Im Bank—you get to help sustain and create jobs in America, and you get to see nice, large infrastructure projects, such as this one, if it should ever get off the ground. And hopefully, it will.

Q. *This morning, Gene Lawson spoke rather pessimistically about American energy projects at the present time in Russia, as though there was something of a slowdown. I wonder if you heard what Gene Lawson said, and how could you explain the difference between what he said, and your somewhat optimistic view? For instance, Gene Lawson said this morning that a couple of years ago everybody was talking about Murmansk.*

JEFFREY MILLER Let me try to address it. I did not hear Gene Lawson, and, by the way, Gene Lawson was a former-Vice Chair of the Ex-Im Bank and we hold him in high regard. I am optimistic, and I hopefully did not misrepresent.

I am high on the potential, and what the need is going to be to achieve that potential. The potential is there, the market is huge, whether it be Murmansk—and I know the problems they are having, and I think I share those concerns. I was trying to bring out today the enormous potential of the cooperation that could happen in the region if they do explore it, and how the international financial community will be necessary. Obviously, the people are going to have to make decisions about that. But the potential for growth, which will ultimately help Russia, is there, and I especially note that their dependence on the energy sector is pretty much the main driver. Unless they start diversifying (which hopefully they will, and they have started a little bit), they are going to need these projects, so the quicker they can get started and get those decisions made, the better. The idea is to get them done. The potential is there, and the market is there. And never underestimate the demand for financing, because exploration is expensive. I do not know if that addresses your question.

Thank you very much for your attention.

Introductory Speaker

ROBERT SUTTER My role is to set the stage for today's panels on the countries of Northeast Asia, and how they are addressing the opportunities and challenges presented by the abundant energy resources situated in the nearby Russian Far East.

I want to provide you with some observations that I have concerning this region over the years, and to describe some dynamics that I see at work.

I worked a great deal in this area when I was the National Intelligence Officer for East Asia and the Pacific on the National Intelligence Council. I spent a lot of time trying to bring together the China, Japan, Korea, and Southeast Asian specialists to come up with an assessment of what was going on the region. It was not easy. People in the government tend to think of these countries individually, and not in a broader context. We did work on it and come up with some assessments, which I have used over the years, and I think they are really valuable. I really think 9/11 has not changed this situation that much when you look at the dynamics in the region. I am talking at a fairly broad level, so I would be interested in your feedback, either here or later.

First, the end of the Cold War led to a lot of transnational issues. We have globalization, terrorism, demographic trends, resource issues, and so forth. A lot of the literature says this has a tremendous impact on governments, and it does. In East Asia, however, you still see that states remain very strong. Governments are very important in this part of the world, and it is especially the case in Northeast Asia. We do have some failing states or difficult states in other parts of the world and other parts of Asia. Indonesia is a good example, and you cannot consider North Korea a big success. But the governments do matter in these places. So government-centered policies are quite important in the post-Cold War period.

A second thing that you can say is that states and the governments themselves tend to be assertive, more assertive than they were in the

past. This is heavily based on their performance. In other words, they have been successful economically and have been developing well, and in turn they have become more nationalistic, particularly on issues of territory and rights. This will be important later when we look at prospects for cooperation among these governments, because it is limited: they are so assertive and nationalistic it makes it harder for them to be cooperative in a regional context.

This leads to a third point, which is of course that the regional rivalries persist. This is not Europe. We do not have a situation like where France and Germany have resolved their issues. This is a situation where the governments of China and governments of Japan are still very much at odds with one another on a whole range of issues. There is also a whole range of other rivalries—among India, China, Korea, and Japan—which come into play, as well as rivalries in Southeast Asia.

A fourth point, which is good because it keeps these rivalries in check, is that governments tend to focus on development. They are into nation building. That is what they are most focused on, and that is a big source of their legitimacy. They are domestically focused and preoccupied with the difficulties they face in dealing with globalization and development. Because of economic dynamism in the region and other reasons, East Asia is looming more important in world affairs.

When we look at East Asia in the post-Cold War period, I think four sets of dynamics are most important in determining the reactions and changes in the region that affect Russia and others.

The first one is that power relations in the region are markedly changing in the post-Cold War situation. In this respect, you see the rise of China, the slow growth of Japan, the rise of India, and the weakening of Indonesia. All of these trends come into play, as well as Russia's more active role in the region, which leads to changing power relations.

A second very important point is the change in the Korean Peninsula. It alternates between thaw and hostility between North and South.

Of course, North Korea's impact on international affairs is having a big change there.

The third point that is worthy of note is that to sustain their governments, the countries in the region are very much focused on dealing with and adjusting to economic globalization and the free flow of information. Dealing with this set of issues influences the dynamic among these governments.

The fourth point, which we in Washington spend a lot of time on, has to do with the role of the United States. The United States sometimes is seen as withdrawing from the region. It is hard to remember, but we are often seen in this context in the post-Cold War period, and then, of course, as becoming over-involved in the region or too aggressive. This is the "sweet and sour" of U.S. involvement, which ranges from worry about withdrawal to worry about U.S. over-involvement and intrusiveness.

I think these four factors are very important in determining the reactions of governments in the region to the situations that they face. What are the results and what are the implications? I think you can generalize about them, but first I would say that you have an uncertain security environment. Now, this environment is not so uncertain that governments seek strong alignments. In other words, we are not in a pre-World War I or pre-World War II situation, but the environment prompts pervasive hedging. The governments seek various ways to protect their interests. This hedging will have tremendous implications for Russia's role in the region.

We also find that most of the governments in the region welcome a strong U.S. presence there. China has been ambiguous on this issue and has now moved to a more accommodating stance. China works with the United States on the one hand, but it hedges and it tries to build a buffer against the United States through its very proactive policies in the region. At times, China has relied on Russia as a counterweight to American pressure, particularly in the 1990s. Japan, of course, aligns with the United States; but on the other hand, it has independent efforts in defense and has a very active diplomacy on issues dealing with China. Japan strives for good relations with all the countries around China's periphery.

India welcomes good relations with the United States, but also has good relations with Russia and tries to improve its relationship with

China. ASEAN (Association of Southeast Asian Nations), in a similar type of situation, try to have relations with all the different powers to make sure that everything is going to be okay in the event that circumstances move in a way that might be adverse to their interests.

South Korea is an excellent example of this kind of hedging. On the one hand, South Korea has an alliance with the United States. On the other hand, Kim Dae Jung has pursued a very active policy of working with the North, the Chinese, and the Russians. In this context, Russia, being the main flanking power of East Asia, is basically very welcomed. China sees Russia as helpful in offsetting U.S. pressure at various times, and has used this relationship pretty actively. This is less the case after 2001, when first the Russians, and then the Chinese, moved to improve their relations with the United States. At the same time, China needs Russian arms to build up their forces opposite Taiwan.

India seeks to preserve its ties with Russia as it pursues better relations with the United States, and with China. Japan seeks to improve its relations with Russia as a hedge in the case of China's rise. And the Koreans, both North and South, have seen Russia's diplomatic role as very important for their interests in various circumstances. This pervasive hedging, which I think derives from the uncertain security situations in East Asia, provides the most important opportunity for Russia in the region. Russia can be very important in this hedging game underway in East Asia, but it depends, of course, in part on the Russians. We will talk a little bit about that and Russia's approach, but I think, this hedging and the opportunity it provides for Russia in the region are key.

In the economic sense, the countries in the region need to work to conform to globalization. Most of them are basically doing this, but they still have to deal with the consequences. As they deal with the consequences of globalization, they find it destabilizing in various ways. In response, they try to organize among themselves in Asia-only groupings and in other groupings to come up with swap arrangements, free-trade agreements, and other structures that will help them manage the consequences of globalization in a way that would be advantageous to their governments. There is an awful lot of this going on in East Asia, as you know. I

believe that most of it is longer on form and process than on substance.

Ed Lincoln has written a good book on this, in which he is pretty negative about the substantive implications of all the activity that is going on in the region. Politically, I think this is important stuff. The governments are interacting with one another. They think it is important, and it does play a role. Clearly, they can do more in the economic area than they can do in the security area because of the continued rivalries among the various countries in the region. In this context, too, you see that through ASEAN+3, the three-power arrangement—China, South Korea, and Japan—and other frameworks that are emerging that these are very important dimensions in the region and that Russia can play a role.

I think that Russia, through its energy, its location, and its importance as a transportation link, has a good deal to offer these governments in this regard. But I think it is probably a lot less than the Russians have to offer in the security area. Russia as a security hedge is probably a lot more important than as a player in the economic arena—not that these countries do not have to worry about economic and energy issues. But the notion of Russia playing a role in helping them to hedge, or to deal with the complications of globalization, is not that likely.

Then there is the political area. The tendency here for the countries in the region is to resist outside pressures on human rights, democratization, and other kinds of issues. The East Asian governments are by and large uniform in this regard. They do not like this kind of pressure. Now, of course authoritarian governments do not like it because it is a direct challenge. But even the non-authoritarian governments, the democratic governments, do not like it, because it is destabilizing to the region. It hurts development and hurts their focus on their nation building. Under these circumstances, they look among themselves to find ways to fend off the United States or the others from the West when they are pursuing an assertive human rights or democratization program. Russia in this context can be seen as an ally or a partner. It has a seat on the Security Council and is an important international voice. Russia can be helpful to these governments in dealing with this kind pressure.

We basically have three types or sets of reactions in the region. We have the security reaction, which tends to focus on hedging. We have the development reaction in dealing with the consequences of economic globalization. And we have the efforts to deal with the pressure they feel from the outside, and particularly from the United States, on political issues in the post-Cold War period. I think we see that Russia can play an important role in some of these respects.

First of all, as the Asian governments are interested in hedging, Russia is very important in the security dimension. Russia can also play an important role for most of these East Asian governments as a counter to Western political pressure. Economically, at least as far as dealing with the consequences of globalization, Russia may not be so significant. It certainly is significant as a source of materials, raw materials, and energy for many of the countries in the region—but as far as a partner in dealing with the consequences of globalization, I am not sure it plays a particularly important role.

Russia's ability to serve as a hedge against pressure on security and political issues depends heavily on the ability of the Russian leadership to respond in an effective way in this regard; in other words, to cooperate, to take initiatives, and to be active. I think the Putin administration has done a pretty good job in this regard as compared to the previous Russian government. They are more organized and are therefore more available and willing to interact with governments in the region and to play this kind of a role. Putin, from the very outset, was doing this with North Korea and in a number of other areas. I think the Russian government's more active approach in Asia works and fits well with this dynamic, as the governments in the region seek a partner and security hedge that can help deal with political pressures from the outside the region.

My final point will focus on the war on terrorism and the effect that it has had on the United States and the dynamics in the Asian region. I look at this pretty carefully, and I try to figure out whether the war on terrorism has had a big effect on this post-Cold War dynamic in the region. There are many areas that you could point to and say that there has been an impact, but I think, in general, it has not changed the broad framework. Obviously, the

As the Asian governments are interested in hedging, Russia is very important in the security dimension. Russia can also play an important role for most of these East Asian governments as a counter to Western political pressure.

United States is much more preoccupied now with other parts of the world, so the U.S. role in Northeast Asia perhaps is not as strong as it once was. It is more reactive. It is certainly reactive in dealing with the North Korean situation. But the United States still remains the dominant power in the region, and if the United States is more passive in Northeast Asia, it is more active in Southeast Asia.

I think the war on terrorism has not changed the situation that much with regards to the governments in the region hedging on security. We still have a very state-oriented model of interaction in the region. Governments still matter a lot in determining policies, and these governments are interested in protecting their interests

in an uncertain environment. The war on terrorism has not really changed that equation much. It seems to me that this is likely to persist, and the Northeast Asian governments have a definite interest in keeping a Russian connection that can be useful for them in this hedging process, and also useful in resisting political pressures. I think is very likely to persist.

So the question is: Do the Russians see their interests well served by cooperating in this situation? My sense is Mr. Putin does, to a considerable degree, and is willing to work with the governments in the region. I thank you for the opportunity to speak and I will stop there. Thank you.

Customers, Competitors, and Partners—Energy Relations in Northeast Asia and Russia

Panel 3

ROBERT MANNING We will get right into this morning's panel. First, I need to give my standard disclaimers so that you do not think anything I say represents the State Department or any agency of the U.S. government. These are my personal views.

I am going to make a couple of quick comments to provide context. We have three extremely well versed presenters, one of whom is actually a practitioner in the energy business. I think you will find them all enlightening. One thing I should mention, as somebody who has looked at this for a long time, is some context on what animates governments.

When I look at China, I see a country that became a net oil importer in 1993 and now, for the first time in 4,000 years, is dependent on external sources of energy. Ironically, the response that they have had very much repeats all the same mistakes Japan has made over the last thirty years in terms of being animated by a kind of a scarcity mentality. Thus, you see the Chinese running around the world buying up oil fields for production and not having full faith in the notion that there is a global market for oil, that oil is fungible, and that there is plenty of it. I do not want to get into that whole debate about running out of oil—just suffice it to say that, as far as I can see, it is not the case and it is not going to be the case. Even taking outside projections for Chinese demand, there is plenty of oil.

I think the biggest problems we face, and the reason we have \$40-a-barrel oil now, have much more to do with politics. Everywhere you look around the world you see major oil producers in some level of uncertainty. You are seeing the current business with Russia and YUKOS, for example, and turmoil in Saudi Arabia, Venezuela, and Nigeria.

The last point I will make is sometimes you hear people talking about how energy cooperation is going to be this great confidence-building measure, and we are going to have “pipelines for peace,” and that sort of thing. I would come out on the other end of that debate—that countries are going to be

extremely reluctant to be dependent on pipelines. India is not going to be dependent on pipelines going through Pakistan until they are confident that the downside risks are pretty minimal in terms of conflict. I think there is great potential, particularly in Northeast Asia, for a range of energy cooperation because everybody has the same dilemma. It has to flow from an underlying confidence that gets reinforced by international cooperation, trans-border investment, and so on. I will stop there.

JAMES DORIAN I will be talking this morning about emerging Russia-China energy relations, and whether needs will be met by supplies. Some of what I will cover was discussed yesterday afternoon by Shawn McCormick, Michael Bradshaw, and Marshall Goldman. So I will try to deemphasize some of those points and emphasize some of the different subject areas that I want to discuss, and I do have slightly different perspectives on some of the issues that were brought forward yesterday afternoon.

I will talk about growing energy consumption in China and offer some statistics. I think sometimes we underestimate the tremendous emerging thirst for energy in China, and what the country may mean to world energy markets in the next ten to twenty years. So I want to provide some perspective on that.

I will look at not only oil and gas, but also nuclear technology transfer between Russia and China. Of course, I will touch upon the Taishet-Daqing oil pipeline proposal, as well as the Nakhodka line and the Kovykta gas line proposal to Northeast China and on to South Korea. I also want to look at some of the geopolitical dimensions of Russia-China relations in terms of the implications for Japan, the United States, and OPEC. Finally, I will outline some future development scenarios that are likely, based on what we know today.

In real estate, there is a term that is commonly used: location, location, location. I would argue that when you are thinking about the future of the world's energy industry, and this includes markets, consumption, produc-

**Coal is king is
China. About
70 percent of
the energy
mix of China is
based on coal.**

tion, and across the spectrum—oil, gas, coal, nuclear—no other country is as prominent and important in terms of influencing global activities as China, especially with respect to consumption. You can argue that Russia is obviously the goliath in terms of oil and gas supplies. But when you look at all of the energy forms, clearly China is a force to be reckoned with and that status will likely increase in the next ten to twenty years. Interestingly, continued strong economic growth in China today is placing enormous strains on its energy industry. We are well aware of some of the power outages that have occurred throughout the country in the past couple of years, and that situation will not resolve itself in the immediate future.

As was pointed out yesterday, last year China overtook Japan as the world's second largest energy consumer. China has the most ambitious nuclear power development plans anywhere in the world. This is very significant, not only for Northeast Asia, but also the United States, France, and other countries in Europe. China has some of the most aggressive plans for gas and LNG development. Last year, China's passenger car sales rose by 75 percent, a dramatic increase. The pace of growth has slowed this year, but it is still very robust. In the first five months of this year, car sales in China were 21 percent higher than this same period last year. This has dramatic implications for the future in terms of oil consumption in China.

Oil consumption will grow to approximately 6.2 to 6.3 million barrels per day this year. Last year, oil consumption rose by 30–31 percent, or 500,000 barrels per day, obviously a dramatic increase in oil use in the country. China's production of oil, however, remains flat at around 3.4 million barrels per day and will remain flat for years to come. There may be a slight increase in output, but most of its major fields are declining in terms of productivity. This is one of the major reasons why China is looking to Russia and Central Asia and other sources for oil. If you look at some of the forecasts that are out today, China can consume anywhere between 9 and 14–15 million barrels per day of oil by 2020, and this would be prompted largely by vehicle demand growth. Today, approximately 35 percent of China's oil consumption is dedicated to ground transportation. By 2010, or soon afterwards, about 50

percent, or half of China's oil consumption would be for vehicle use. It is therefore very important to try to understand how many new vehicles will be purchased or put on the roads in China over the next decade or two.

As was discussed yesterday, Beijing is promoting natural gas usage. In fact, it plans to double its consumption of natural gas from about 3 percent today to 6 or 7 percent by 2020. This is in part to help alleviate some of the coal and power shortages. Somebody yesterday raised a point about coal in China, and I think that was a good point. Coal is king is China. About 70 percent of the energy mix of China is based on coal. So, despite the fact that you will see dramatic increases in gas and oil and even nuclear consumption over the next decade or two, it is wise to keep things in perspective. Coal is king, it has been for decades, and it will be for decades. So perhaps we should be taking coal more seriously in China at conferences here in Washington, because it is very significant. As we all know, the environment, the air quality in China is terrible—we could probably do more to transfer clean coal technologies to China.

The increasing oil imports into China are not without cost. The overall bill for foreign oil last year rose by more than 50 percent to about \$20 billion. That oil import bill is expected to top \$30 billion this year. Rising gasoline prices are a significant factor in China's surging economy, which are leading to higher transportation costs. These increases in transportation charges are filtering down to many staple items, such as wheat, rice, and vegetables. As a result, you are seeing inflationary pressures brought on by the rise in gasoline prices in China.

If China follows a similar economic growth pattern as South Korea, Taiwan, and Japan over the next fifteen years, with approximately 6 to 6.5 percent average annual economic growth rate, it is reasonable to believe that China could add as many as 150 million new vehicles to its roads by 2020 (**Figure 13.**). There are roughly 20 million vehicles in China today. I do not know how many of you have been to China very recently, but the country is very anxious to develop an auto export industry on par with Japan. They feel that in order to compete with Japan and become a superpower, they need to develop an auto export industry and take over a large share of the market in China. Right now,

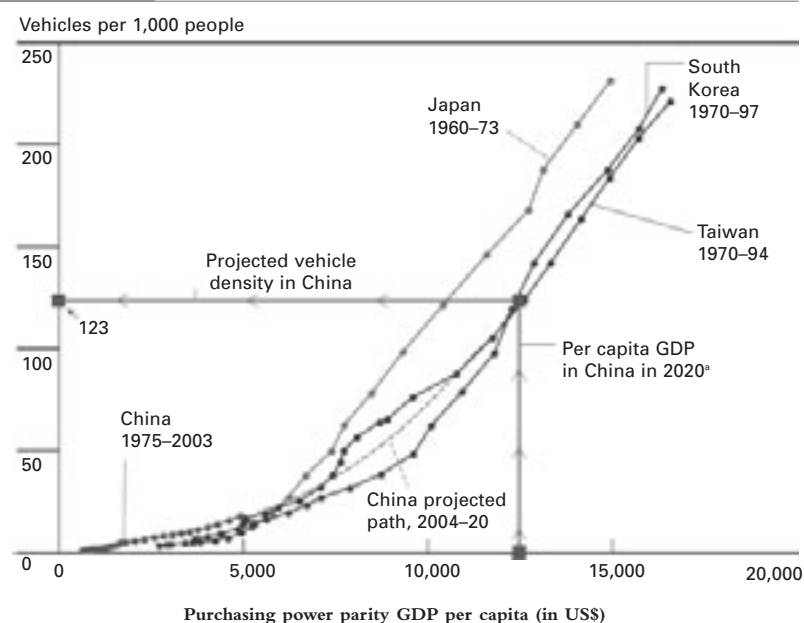
they are developing conventional vehicles. There is some talk now about introducing the hybrid into China. But even with the introduction of hybrids into China, the rise of oil consumption, because of new vehicle use in China, will be dramatic over the next ten to fifteen years. This in turn will fuel increased oil consumption from the Middle East and other sources.

As I mentioned before, China is currently suffering through power outages in about two-thirds of the provinces in the country. There is no reason to believe that these power outages will be resolved any time in the next few years. The east coast in particular is suffering through some of these power outages. It takes a number of years to build new power plants, so they do not expect these problems to be resolved any-time soon. One of the major reasons why you are seeing power outages in China is because coal is being stranded at some of the major mine sites. The infrastructure system, and particularly the railroad network in China, is already over capacity. You are seeing competing demand for railroad cars between coal suppliers, iron ore, steel, and other consumer goods. These problems are so severe and so widespread that they will have to be seriously addressed over the next several years if China's government wants to maintain robust economic growth.

About two-thirds to three-quarters of China's energy mix is based on coal, and they expect to consume anywhere from 2 to as much as 4 billion more tons of coal by 2020. In order to do that, they have to drastically revamp their infrastructure system. Problems in coal are leading to problems in power. Also, there has been a drought in parts of China. Hydropower is fairly significant in China, and this drought has adversely affected hydropower generation. With all of these problems and potential future bottlenecks in energy, China is looking to Russia and other sources of future energy supply.

Chinese interests in Russian energy really began in earnest a decade ago. In 1993, China became a net oil importing country. Until that time, China was actually hoping to achieve energy self-sufficiency. In the 1980s, the Chinese geologists had boasted about the Tarim Basin in Xinjiang, China. Geologists had felt that the Tarim Basin would provide enough oil to solve all of China's future energy problems. But those estimates were overly ambitious. The geologists

Figure 13. Projected Vehicle Ownership in China, 2020, as Compared with Historical Trends in South Korea, Taiwan and Japan



*Based on average annual GDP growth rate for 2001-25 of 6.2 percent, as projected by the US Energy Information Administration, and a 2020 population of 1.4 billion.

found that the oil in the Tarim Basin is much more deeply situated than they had expected, meaning it is much more costly to extract.

So by 1993, China became a net oil importing country and it started looking in earnest at Russia, and Central Asia, and parts of Africa for additional energy supplies over the long term. Beginning in the early 1990s, you saw companies from Russia, such as YUKOS and Gazprom, starting to negotiate with Chinese National Petroleum Corporation (CNPC), and later on, PetroChina in Beijing.

Let me briefly mention the oil and gas pipelines that were discussed to some extent yesterday. The first thing I would mention is that I have been examining and writing about these pipelines for about fifteen years now. I raise this point because, as Michael Bradshaw so eloquently stated yesterday, the Sakhalin projects have been discussed and evaluated for three or four decades. These pipelines were proposed long, long ago. If you look in the Soviet literature, as well as Western press, you can see references to these pipeline routes, as much as 30 to 40 years ago. And I raise that to provide some perspective. Often times when you read the press or magazines and they say that the Chinese reached an agreement to build a gas pipeline, or to have Russia build a gas pipeline,

keep in mind that these same pipelines were probably discussed decades ago. There is no reason to believe a major pipeline project would be developed in a year or two.

Regarding the Taishet-Daqing oil pipeline, let me note that Angarsk was the original beginning point of the oil pipelines to Daqing or to Nakhodka. The environmental groups in Russia have convinced the Russian government to move the beginning point of this pipeline a little further west and a little further north to Taishet as the originating point to completely avoid Lake Baikal. This pipeline to Daqing would have a maximum capacity of perhaps 600,000 barrels per day. Approximately 4.4 billion barrels of economically recoverable reserves would be required to support such a pipeline. As was pointed out yesterday, the Nakhodka line is competing with this line. The cost estimates for the Nakhodka line have now increased to about \$13 billion. The Japanese are actively lobbying for the Nakhodka line. The Chinese, in contrast, have pretty well given up on the Daqing pipeline.

Interestingly, the oil reserves in place in Eastern Siberia really have not been discussed. To my knowledge, the oil reserves in place in Eastern Siberia have not yet been adequately assessed or evaluated, and it is very questionable whether or not there are recoverable reserves that are sufficiently large enough to support either of these pipelines, and particularly the longer line to Nakhodka. The other issue with that Nakhodka line is the cost estimates are now up to about \$12 to \$13 billion. The Japan Bank for International Cooperation (JBIC) is leading the effort to acquire financing for that project. Japan has pledged to pay for about 80 percent of the total costs of the project. JBIC has not yet found or identified any commercial banks within Japan that would participate in the financing structure of this project. So you not only have the oil issue as a potential bottleneck, but the financing of a Nakhodka line is still not completely resolved.

Shawn McCormick offered a very good update on the Kovykta gas pipeline to Northeast China and South Korea yesterday. As he pointed out, the costs have now risen to about \$18 billion for this gas pipeline. It would go to China and then on to South Korea. There are a couple of things to keep in mind with respect to this project. The principal bottleneck to date has been identifying and defining the role of

Gazprom. As Shawn appropriately pointed out, TNK-BP is now negotiating with Gazprom to define that role. Gazprom, about a year ago, was charged with exporting all gas to Asia. In other words, the Russian government in Moscow told Gazprom that they would have the authority to export any and all gas to Northeast Asia including, of course, China and South Korea. That is the role that Gazprom wants to play in this project. This is very interesting from a status perspective. The final role that is decided for Gazprom will reflect the level of control that the Russian government wants over its gas industry. And it seems increasingly clear that Gazprom will be responsible for exporting that gas to China, if in fact the project takes place.

There have been some other bottlenecks, as was pointed out yesterday. The Chinese are asking for reduced prices for gas. They feel that the gas that they would import from Russia should be priced comparably to coal. The South Koreans have asked for a 30 percent reduction in price. So there are other issues at stake. But, as Shawn mentioned, TNK-BP is working with Gazprom to try to finalize some of the details on this project. And I agree with him that the window of opportunity is fairly short with this project, because there are so many other projects in terms of LNG exports to China that may be competitive with this pipeline gas. TNK-BP basically feels that if this project is not finally agreed upon in the next several months, China will have already reached agreement with Sakhalin-2, perhaps, to import LNG.

The map in **Figure 14** shows these potential gas and oil pipelines. Taishet is slightly to the west and north of Angarsk. The Russian government in the last two or three months has made a new suggestion about the Kovykta gas pipeline to Northeast China and on to South Korea. Some in the government, and some in Gazprom, have suggested that the gas pipeline parallel an oil pipeline to Nakhodka, where they would build an LNG terminal. This would be completely unacceptable to TNK-BP. TNK-BP is interested in developing this gas pipeline to China. As Shawn had mentioned yesterday, they have spent as much as \$800 million assessing the gas market in Northeast China and they are not at all interested in LNG, they are interested in getting that gas to Northeast China and marketing it there. So I do not believe that suggestion is being taken seriously.

The map in **Figure 14** shows the oil and gas resources in Eastern Siberia. Taishet would be the beginning point of an oil pipeline that would avoid Lake Baikal, the national forests, and some of the environmentally sensitive areas there. Also noticeable from the map is a lack of infrastructure in this area. This goes back to my earlier point that the oil reserves in place in Eastern Siberia have not yet been adequately evaluated. You can simply go on the YUKOS website, and they will explain that they have been conducting geological and geophysical activities in Eastern Siberia for the last 2 or 3 years. It sometimes takes many, many years to conduct very detailed exploration and drilling activities to confirm economically recoverable reserves.

I believe that the oil pipeline proposals in Eastern Siberia are a case where the cart was brought before the horse. The pipeline route was identified and even the terms of the contracts with Japan and China were identified and detailed for 20 to 25 years; yet they have not yet assessed the oil resources in Eastern Siberia. So that certainly would have to be done. All indications to this point suggest that the region is a much more gas-prone rather than oil-prone area. Production costs for oil fields in Eastern Siberia would be much higher than in Western Siberia. Many people believe that Eastern Siberia will resemble Western Siberia in terms of its oil production potential, and that is not necessarily the case.

Regarding Sakhalin, Michael touched upon this yesterday. China is sending a delegation this month to Sakhalin to discuss the possibility of reaching a long-term agreement for importing LNG from the Sakhalin-2 project, where Shell is the primary operator. Three Japanese companies have already reached an agreement. These are electric utility companies in Japan that have already signed agreements to import LNG on the order of 2.8 or 3.0 million tons per year over a 20-year span. From my understanding, there are perhaps as much as 6 to 8 million tons of LNG a year available from this project. So there is certainly room for China to reach a long-term agreement from Sakhalin-2.

Now, if this happens in the next month or two, what would be the impact on the Kovykta gas project? I think TNK-BP would claim that they are separate and they could both go on at the same time, and that pipeline gas is different than LNG gas. Perhaps Michael could weigh in

Figure 14. Russia: Proposed Gas and Oil Pipelines to the Far East



Selected Oil and Gas Infrastructure

Figure 15. in Eastern Siberia, Russia



on that, but it is an interesting prospect. If the Chinese reach some sort of agreement, this may affect ongoing negotiations with Kovykta. The map in **Figure 16** shows a close-up look at Sakhalin. The southern gas field on the right would be tapped for Sakhalin-2 and piped down to the southern most point of the island, where it would be sent to an LNG terminal.

Figure 16. Selected Oil & Gas Infrastructure on Sakhalin Island, Russia

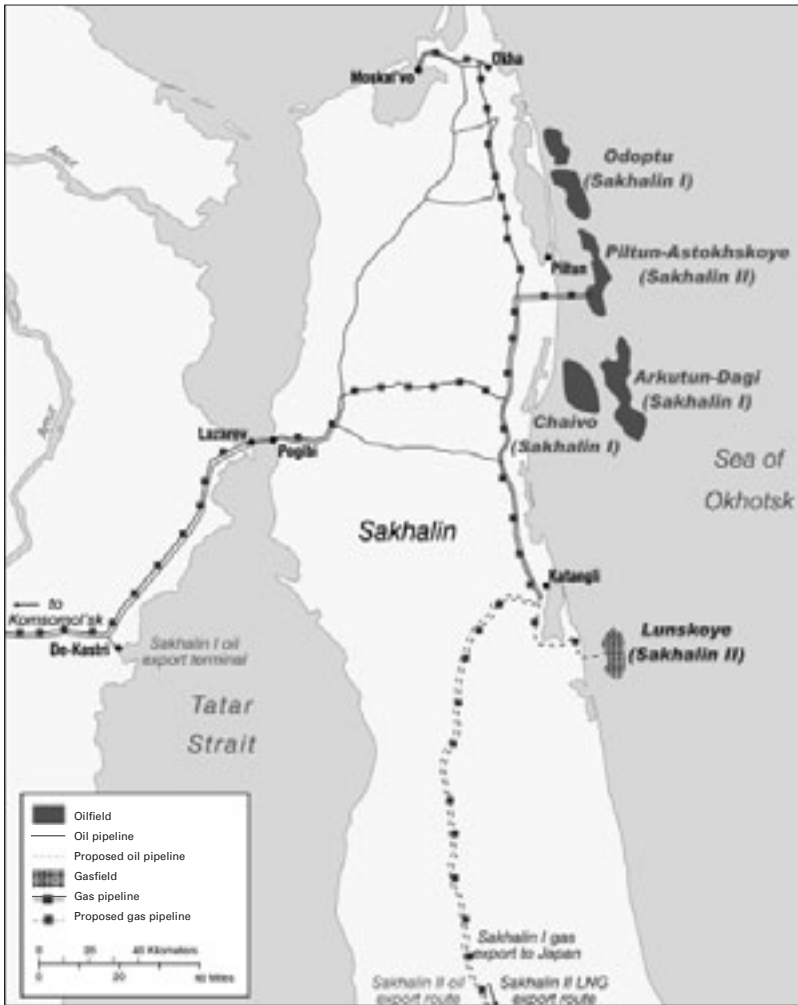


Figure 17.



Let me move away from oil and gas, and say something about nuclear power in China and the ambitious plans that have been put forward this year in Beijing. As I mentioned at the outset, China clearly has the most ambitious nuclear power development plans of any country in the world. They have suggested that they will build as many as 24 to 32 new nuclear power plants by 2020. In my opinion, this is unrealistic for a number of reasons; but nonetheless, it reveals the expectations that the Chinese government has for developing nuclear power to supplement its overall energy resources. They want to quadruple nuclear power capacity to about 4 percent from the current level of about 1.4 percent of their total energy mix. Keep in mind, a quadrupling of the nuclear power capacity will still make nuclear power insignificant compared to the importance of coal to the overall economy. You are talking about going from 1 percent to 4 percent, whereas coal represents about 70 percent of the energy mix in China. But nonetheless, it is a dramatic announcement and particularly important with respect to Russia.

Russia is currently the largest nuclear technology supplier to China. They are now helping to construct nuclear power plants at Tianwan and Jiangsu, and also an experimental reactor at Guangdong. The map in **Figure 17** shows the existing and some of the proposed nuclear power plants in China. As you would expect, the plants are mostly concentrated along the east and the southern coasts. The specific locations of these 24 to 32 nuclear power plants have not yet been identified, but one would believe that if only a few are built, they would be built in the east or the southern areas where the industrial centers are and the population centers are. The cost of a typical nuclear power plant could reach \$2 to \$2.5 billion. So if 30 new nuclear power plants were built, that represents a \$60 billion cost. If you add those costs to the costs of these pipelines, the cost of revamping and expanding their infrastructure system, and then add in the problems with water resources, air quality, all of the other problems in China, the question arises—where will all the money come from?

Certainly, there are geopolitical dimensions to the Chinese energy industry and energy policy. I think it is important to note that energy in China is critical to the nation's economy. It promotes economic growth and job and social sta-

bility. In 1993, when the Chinese officially abandoned their energy self-sufficiency ambitions, they recognized that their most important priority was maintaining robust growth and maintaining employment, because there are as many as 250 million unemployed in China. The energy industry employs millions of people, particularly in coal. China will do whatever it takes to acquire the additional energy resources that it needs over the next 10 to 20 years, in my opinion, because they want to maintain a robust economy and high employment level. One thing to note is that with these increasing oil imports, most of those oil imports would be from the Middle East. This raises some questions about the United States and Japan competing at least indirectly for the same Middle East oil supplies over the next 10 to 15 years.

It is very interesting to note that Russian oil production has increased by about 40 percent, or 2.5 million barrels per day, since 1998. This increase in oil, most, if not all, of which went to international market, more than compensated for the increase in oil consumption in China during that same period. In fact, it represents about 25 percent more oil than China consumed above and beyond the 1998 levels.

Looking to the future, there are certainly some questions with respect to the proposed oil pipeline to Daqing. There has to be sufficient oil in place to fill that pipeline either to Daqing or Nakhodka. YUKOS had originally proposed siphoning off 200,000 barrels per day of Western Siberian oil to fill the Daqing line, at least initially. But whether that could be managed over the long term is a very difficult question to answer. Russia will continue to pursue China as an oil, gas, and nuclear market, but they will face stiff competition in the nuclear area. The United States and France are already meeting with the Chinese regarding selling nuclear technology over the next several years. And of course, a number of LNG plants are being proposed around Asia and some of these may serve the Chinese market. There are as many as nine LNG terminals planned along the east and south coasts of China, so they are certainly looking to LNG in addition to the pipeline gas from Kovykta.

The last point I would make concerns these power shortages and the constraints in the coal sector. If you look down the road, unless some

of these infrastructure constraints are resolved, energy bottlenecks can well indeed affect the economy of China. I do not think this point has been highlighted much, but again, today they consume around 1.5 billion tons of coal. That may rise to 3 to 5 billion tons of coal by 2020. If China does not expand their infrastructure system dramatically, which would be extremely costly, *and* combine that with perhaps no oil or gas from Russia, they would have some serious concerns. So I will leave you with that thought and look forward to your questions. Thank you.

JOSEPH FERGUSON I am going to talk today about the politics of Japanese-Russian energy cooperation. I initially was going to call this talk “The Geopolitics of Japanese-Russian Energy Cooperation,” but Japanese-Russian energy relations are deeply rooted not only in economics markets and geopolitics, but also domestic politics.

I am going to talk first about the perspective from Japan on Russian-Japanese energy cooperation and mention a few of the players there in terms of economics and policy. Then I am going to talk a little bit about the perspective from Russia. Then I am going to focus on the geopolitics of the issue, with a focus on the Eastern Siberian pipeline, which threatens to really poison the trilateral relationship between China, Japan, and Russia. And then I will wrap up at the end with a short glance at the prospects for more multilateral energy cooperation in Northeast Asia.

This Japanese-Russian energy cooperation has been getting a lot of attention over the last year or so. But in fact, as others have pointed out, this has been talked about for decades. In the 1960s and 1970s, there was talk about grand energy projects linking Japan and Russia; indeed, there was some Russian energy shipped to Japan. But for the purposes of what’s going on today, I am going to start in 1996, which I think was a real watershed year in Russian-Japanese energy cooperation. That was the year that the agreements were inked on the Sakhalin-1 and -2 projects, which, as Jim mentioned, have major Japanese representation. In Sakhalin-1, the Sakhalin Oil and Gas Development Company, which is actually a Japanese company, is a major partner. Mitsui and Mitsubishi are actively involved in the Sakhalin-2 project. This is not to mention the gas

projects on Sakhalin. It was also a watershed year, because 1996 was the year Ryutaro Hashimoto became Prime Minister of Japan.

Before Hashimoto was Prime Minister of Japan, he was the Minister of MITI, the Ministry of International Trade and Industry, which is now called METI, Ministry of Economics, Trade, and Industry. In this presentation I am going to use them interchangeably. Hashimoto was Minister of MITI in 1994. At that time, he was behind an initiative that came out of MITI called the “Support Plan for Russian Trade and Industry.” And a big part of this concerned energy cooperation and helping Russia with financing and technology to get a lot of their badly battered energy infrastructure up to speed.

It is interesting that Hashimoto very much resembled the Prime Minister in 1972, Kakuei Tanaka, who, prior to that, had also been Minister of MITI. Tanaka also had made a big push in MITI in the 1960s and as Prime Minister in 1972 and 1973 for Russian-Japanese normalization in order to get energy projects off the ground. Hashimoto had this same background. MITI’s influence grew, obviously, when Hashimoto became Prime Minister. In his landmark speech outlining Japan’s Eurasia policy in 1997, large parts of it were actually written by some of his former colleagues in MITI. Hashimoto was also a member of the very influential Energy *Zoku* in the Japanese parliament, the Diet. The *zoku* are special interest groups of politicians within the Diet who have an interest in particular areas. Hashimoto was a member of the Energy *Zoku* with some other very influential politicians in Japan, including Yukihiko Ikeda, the former Foreign Minister; Shinji Sato, a former Minister of MITI; and Seiroku Kajiyama, the Chief Cabinet Secretary at the time. The closest equivalent here to the Cabinet Secretary would be the president’s Chief of Staff, but the Cabinet Secretary is much more powerful than the Chief of Staff here—he is an elected politician. There was a confluence of like-minded politicians around this time, and there was a big push made to normalize relations with Russia.

The Sakhalin projects got off the ground. There were some setbacks in 1998 because of the financial crisis in Russia, but they were back on track in 2000. Oil from Russia started arriving to Japan after 2001 for the first time since the early 1980s or late 1970s. Ironically, the first

bilateral energy cooperation between Japan and Russia in the late 1990s involved the transfer of Japanese fuel oil to Russia because of the beleaguered state of the Russian Far East and the power outages there. Two of the four islands disputed between Japan and Russia, Kunashiri and Shikotan, actually were completely without energy in the winter of 1999. Japan transferred somewhere in the area of 400 tons of fuel oil to these islands to help them restore power. It is ironic that the Japanese were the first to send energy back to Russia in the 1990s.

Japan has also been very interested in being involved in other projects in Russia. The Japanese firms Mitsui, Itochu and Sumitomo are building part of the Blue Stream pipeline project, which has been an off-and-on affair, linking Russia to Turkey across the Black Sea. Most recently, the Japanese government has agreed to pay \$76 million to the Russians for a feasibility study for the route of the Nakhodka pipeline. I will touch a little bit more on this later. But it should be pointed out that they want to have this feasibility study released in time for Putin’s planned visit to Japan in early 2005. Hashimoto left office, and the influence of METI on policy towards Russia waned somewhat, but METI is still a major player and they are very much interested in being involved in energy projects in Russia. The only problem is they are having a hard time finding private companies in Japan that share their interest.

I will talk a little bit about Russia now. Around the time that there was this confluence of events in Japan, there was a similar dynamic in Russia that boded well for Japanese-Russian energy cooperation. You remember 1996 was the year that President Yeltsin was re-elected. The influence of the economic reformers was growing. This group was led at the time by Anatoly Chubais, who served in a number of different official positions under Yeltsin. He had prevailed in his personal battle with another Yeltsin advisor, Aleksandr Korzhakov, who had wanted to cancel the elections. Another rival, General Aleksandr Lebed, was eventually pushed out as National Security Advisor. Sergei Kiriyenko, a close ally of Chubais, was appointed Prime Minister in 1998, and he had previously been the Minister of Fuel and Energy. Another liberal reformer, Boris Nemtsov, was considered a rising star around this time.

This triumvirate was very interested in energy cooperation with Japan, not necessarily for reasons of geopolitics, but because they realized that they needed money to get the projects off the ground. Probably the best place to find that money was in Japan. None of them really had a Japan background, although Nemtsov was actually one of the few people that went with Yeltsin on his trip to Krasnoyarsk and was sitting next to Yeltsin during his talk with Hashimoto on their boat trip up the Yenissei River.

Chubais went to Japan on two occasions, in 1998 and 2000, in his capacity as Head of United Energy Systems (UES). He proposed a grand Sakhalin energy bridge that would link up Japan and Sakhalin with energy grids, electricity, and other infrastructure. Chubais ran into the problem of where they were going to get the money, which is a recurring theme in the Russian energy industry. With Japanese-Russian energy cooperation, the will is there, but the financing is difficult to bring together—not necessarily for reasons of politics, but more because Japanese companies want to see economic benefits to cooperation. They are not going to be pushed into anything that they feel is not going to give a return on investment. Although the politics of the Kurile Islands and the territorial dispute help explain their inability to come together in major projects, in the end, if it made sense economically, you can bet that the Japanese companies would be there. ExxonMobil also expressed interest in building a gas pipeline linking Sakhalin and Japan. The problem with that is there is not a main trunk gas line that runs the length of the Japanese archipelago. The Japanese natural gas industry has very much relied on liquefied natural gas up to now. They had been importing large amounts of LNG from Southeast Asia and the Middle East, and they are still doing so. Their facilities on the Pacific Coast are very much linked to liquefied natural gas, and not piped gas, which would come down from Sakhalin. Once again, there is the question of building infrastructure and getting the money.

I apologize for not being here yesterday, and I do not want to reiterate anything, but I am sure you covered the proposed Eastern Siberia Nakhodka pipeline. I will touch on this a little bit. Obviously, YUKOS favored the pipeline to Daqing, whereas Transneft, the state-owned oil

pipeline company, favored the route to Nakhodka. The leadership at Transneft has been very vocal about this. Simeon Vainshtok has been clear that he wants to have a pipeline that skirts Baikal, skirts China, and goes to Nakhodka. In a speech a week or so ago, he said, “Russia does not need to have any of its energy pipelines going through foreign countries.” Now, this statement was actually made in reference to pipelines in Europe and the Baltics, but you could also interpret that he does not want to have pipelines going through China, either. The V.P. of Transneft has said that Nakhodka makes sense for geopolitical reasons. I think it is quite interesting having a business leader saying that geopolitics factors into their decisions. It is hard to imagine someone from one of the Western majors, Lee Raymond or Lord John Browne, saying, “We need to do this because it makes sense for our country geopolitically.” So that does say something about what has been going on. There are well-placed analysts, at least from the Transneft perspective, saying, “Yes, it is dangerous and it is risky to rely on one country like China as an outlet for our energy resources.”

But what makes this all the more interesting is that in April of 2003, Vainshtok was on record as saying that “Nakhodka just doesn’t make sense economically. There is not enough oil.” As Jim has pointed out, they need something to the order of 500,000 to 600,000 barrels a day to fill a pipeline to Daqing. They need more than a million to make the pipeline to Nakhodka economically feasible. Right now, the resources just are not there. The latest cost estimates, again as Jim mentioned, for the pipeline to Nakhodka run between \$12 and \$13 billion. The Japanese have said they would fund up to \$7 billion. I guess there is more recent analysis that says they will fund up to 80 percent, but as the price goes up, the Japanese are going to be less and less willing, I think, to agree. This echoes what happened in the 1970s—as the estimates were made for energy projects, each month the estimates went up and up. In direct proportion, the Japanese interest in the project went down and down each time the amount of the pipeline went up.

Vainshtok said that initially he would help fund this from the extra money he will get by transporting oil to Nakhodka via the northern branch of the Trans-Siberian Railroad, the

If the experts all agree that there is not enough oil, and if there is not enough money, then why the big push? Well, I think in a word it is “geopolitics.”

Baikal-Amur Mainline—the BAM railroad. Most of you probably know the history behind the development of that line. It was painstakingly built up over many, many decades to give Russia strategic depth in the Far East in case there was any sort of problem with China back in the 1960s and 1970s. It was built not as necessarily a threat to China, but a response to China. And so it is interesting that they are talking about the BAM again in the context of skirting China. Gazprom, as Jim mentioned, is also interested now in building a pipeline that would parallel the Nakhodka oil pipeline. They are really kind of muscling in at the last minute. I am not an expert on the statistics, but it seems to me that it does not make a lot of sense.

If the experts all agree that there is not enough oil, and if there is not enough money, then why the big push? Well, I think in a word it is “geopolitics.” If you line up the geopolitics along with the domestic interests that I alluded to earlier, those are really two strong factors in pushing this forward. Japanese interest in Russian energy is very clearly rooted in geopolitics.

It is interesting. I was looking at one of the maps that Jim put up, and the town on the northern tip of Sakhalin, Okha, was actually the site of some of the earliest Japanese oil fields outside of Japan in the early 20th century. Japan has always been consumed with energy and security, as the drive to Southeast Asia in the 1930s and 1940s has shown. I do not mean to speak from the viewpoint of the Japanese, but you can kind of detect a mercantilist bent to Japanese strategy.

Five years ago I was writing a dissertation on Japanese-Russian relations, mainly political relations. I interviewed a lot of Japanese officials in the energy industry and in the government about energy cooperation with Russia. When I asked them about it, they said, “Well, in one word, China.” I expected to hear, “Well, you know, China is consuming all this energy, and we need to get the energy before the Chinese do.” Well, at the time, they were actually saying, “We need to develop this energy so we can help feed China. China’s energy demand is rising rapidly, and if we can help develop this Russian oil and get it down to China, it would really help us. It would help stabilize world markets and keep the prices down. Plus, we can help build the pipeline, and our companies can profit from this.” Well, you do

not hear that anymore today. Somewhere the cooperation went out the window. I do not know when it happened or exactly why it happened. I have ideas of why it happened, but I am really anxious to go back and speak to those same people that I did five years ago and see what they have to say about that now.

Russia’s interest in cooperation with Japan also seems to be geopolitically inclined. I pointed out the view from Transneft. Well, I think in the Kremlin there was also a perception that in 1999, the last year of the Yeltsin administration, Yeltsin had leaned a little too closely toward China. You may remember this is when the bombing in Yugoslavia was going on, and when we bombed the Chinese Embassy, there was a really big backlash in Russia. I was there at the time, and I remember the eggs and paint thrown at the U.S. Embassy.

When Putin came in, people were saying that he was going to try and rectify this and have a more balanced policy in Asia. He was going to look to firm up relations with China and Japan and make them very balanced. The governors in the Far East are obviously very concerned about being overtaken demographically and economically by China, and they are interested in perhaps seeing that the pipelines run through their territories. That would provide more benefits than having the pipeline go directly into China.

I am going to conclude by talking a little bit about the multilateral prospects. At this stage on Sakhalin, it seems that prospects for multilateral cooperation are fairly good; indeed, they are actually underway in places. There are even one or two companies from India that have invested in some of the projects in Sakhalin. South Korea is involved as well, and now I hear there is an interest from the Chinese to be involved. But when you move to the mainland in Russia, I think it is going to be much more difficult to find cooperative efforts. There has been, obviously, some in the gas projects with Korea, China, and Russia. I think, however, that Russia would be more interested in dealing bilaterally with other countries when it comes to energy projects that are going on in their territory. Sakhalin is different—it is offshore. I recognize that it is Russian territory, but I think the mentality of the whole process is a little bit different.

Another thing that makes it seem difficult to imagine multilateral cooperation is that in Asia,

you still very much have the mindset of a zero-sum outcome to things and a mercantilist bent to economic and to energy strategy. There is the perception that “if we do not get these supplies, then someone else is going to get them.” Oil is a very fungible commodity, but there is less of a tendency to rely on markets to help resolve issues in Asia. Until they get over this tendency, multilateral cooperation is going to be hard to achieve.

As far as bilateral cooperation between Japan and Russia, I will echo again that when it makes sense economically, it will happen. Politically, the Japanese government has in recent months reaffirmed their strong demands for the return of all four of the disputed islands before they move forward. There had been a slight shift in policy over the last five years, but that all came crashing down in the political scandals in the Japanese Diet. And it is interesting that the Japanese want to schedule the upcoming Putin visit to Japan on February 7, which is Northern Territories Day. On that day, all over Japan and you will see banners saying, “Give us back our Northern Territories.” Well, Hashimoto was invited to Russia a few years back on September 2, which is VJ Day. There are not great celebrations throughout Russia about this; obviously, VE Day, May 8, is the big day in Russia. But, inviting Putin to Japan on this very day it sends, I think, the wrong signal. Although economics will probably rule in the end, political issues are still going to be a big thorn in the bilateral cooperative process. And I will end it at that.

JOHN FETTER We have heard a lot about the politics of government interaction. My interest is in Korean access to Russian energy, and in the overriding fact that energy is going to drive Russia’s integration into Northeast Asia. Russia has a real interest in getting back into Northeast Asia. Ten years ago, when the Soviet Union fell apart, Russia sort of disintegrated—not disintegrated, but *dis*-integrated—from Northeast Asia, in particular the Korean Peninsula. They were a strong supporter of North Korea. Most of the energy infrastructure in North Korea came from Russia. Their departure has had a hugely detrimental effect on North Korea and in fact on Russia’s role and influence in Asia.

As we all know, there are two Koreas. As it was so accurately pointed out to me by a North

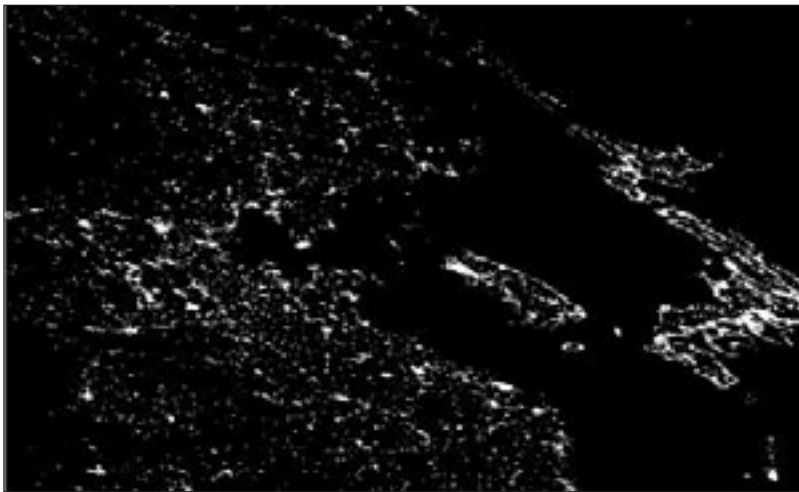
Korean who I was talking to at one point in time, “If it weren’t for the United States, there would be no North Korea. You created this problem. You need to play a role in resolving it.” My argument right now is that the United States does have a very significant role in Northeast Asia. But if they do not play a more positive role in supporting their allies in Northeast Asia, the significance of that role is going to diminish and it is going to diminish fast. Last year, when there was a poll in South Korea asking whom they feared more, George W. Bush or Kim Jung Il, George W. Bush won 2 to 1.

Energy is critical to the development of North Korea as well as the rest of Asia. It is critical to the development of China. We heard a comment that China plans to put another 150 million cars on the road by 2020. I do not know how many of you have ever tried to drive around the ring road in Beijing to get to the airport in a timely fashion, but I am wondering where they are going to put those 150 million cars without getting rid of a few bicycles. At any rate, the need for energy in North Korea is critical, but it is equally critical for the South Koreans. Not only do they want one Korea because 30 percent of them have living relatives in North Korea, but also because the South Koreans need access to cheaper labor to remain competitive in the Asia world markets. As a result, the South Koreans are very interested in integrating with North Korea from an industrial perspective, and they are going to go ahead and do that whether the United States supports it or not.

In fact, today, Roh Moo Hyun and the South Koreans are moving forward with KOLAND, which is a government entity in South Korea that is building an industrial facility in Gaesong. This facility is going to employ roughly two million North Koreans—that is something on the order of 10 percent of the North Korean population. Why? A North Korean working in Gaesong making \$60 a month is a very, very happy worker. In South Korea, they are paying \$15 an hour to that same worker. If you were Hyundai putting cars together, where would you want your next facility? They can do this. Kaesong is closer to Seoul than it is to Pyongyang. They do not have to translate their instruction manuals into Chinese or some other language. It works well from a lot of perspectives. It also allows them

Another thing that makes it seem difficult to imagine multilateral cooperation is that in Asia, you still very much have the mindset of a zero-sum outcome to things and a mercantilist bent to economic and to energy strategy.

Figure 18. View of the Korean Peninsula from Space at Night



to become competitive with China and other countries, and it helps them move towards their view of one Korea.

You ask why do we integrate into Asia from an energy perspective. In a typical satellite view of Northeast Asia at night, you will see a dark hole—North Korea. (**Figure 18.**) When you talk about the political aspects of energy in Asia, North Korea is like a cavity in a tooth. If it would just stay where it is, everybody would be happy. But unfortunately, it doesn't work that way. You cannot have this economic void in a region without addressing it and without being somewhat proactive.

There are two types of energy that we are talking about here—one is primary energy from fossil fuel, the other is electricity. Only a small section of Northeast Asia runs on 60Hz electricity, the rest runs on 50Hz electricity. Therefore, electrical integration is much more difficult than integrating from a gas or oil perspective. There are a number of different ideas for power transmission lines to make power in Russia where the fossil fuels are available, and then transmit them down either through China into North Korea, or directly into North Korea from Vladivostok, from Russia, as well as up from South Korea. Beyond the technical issues of switching between transmission frequencies, there is the antiquated state of electrical distribution in North Korea, where you can find stripped pieces of automobile radiators serving as handles for electrical switches. Unfortunately, that is the reality of electrical distribution in the rural parts of North Korea.

Next we will look at what fuels they have used to generate electricity. In **Figure 19**, we see the total electric generation by fuel in North Korea from 1990 to 2000. For the last day and a half we have been talking about growth in China, growth in Japan, growth in South Korea. In North Korea, electric generation has dropped by two-thirds over the last 10 years. Over that period, hydropower has maintained some sort of normalcy, though it has been affected by the weather. If you take a look at coal-fired and/or oil-fired power in North Korea, it has virtually evaporated. Part of that has been because as part of the 1994 accord, the United States agreed to provide some heavy fuel oil to North Korea, which had more sulfur than any reasonable person would want.

What has that done to the North Korean economy? Well, if you look at the North Korean economy, and energy consumption in 2000 is 75 percent less than energy consumption in 1990. What does that mean? The industrial economy has gone away. The industrial economy truly does not exist. And this was an industrial economy that was dominant in 1970 or 1975 in Korea. North Korea was the industrial power in Korea when the Korean War was resolved, using that term loosely. Now, that industry no longer exists. When you look at energy consumption by fuel, you have declining coal consumption and declining fossil fuel consumption, and what you have left is wood and biomass. North Korea has regressed to burning whatever they can find to keep warm in the winter and cook.

There have been a number of words said about LNG, pipeline gas, and other projects. I want to think a bit about energy use in terms of a time continuum from 1850, when the fuel was primarily (a) solid, (b) easy to handle, (c) hugely polluting, and (d) not sustainable. Moving forward across this continuum, you notice several things. First, you are moving from fuels with higher carbon content to lower content, which relates to the greenhouse gases addressed under the Kyoto Protocols. You are also moving from fuels that are easy to handle to less easy to handle. When you chop a tree down, you can put it on a cart and haul it over to your neighbor a mile away. When you start using gases and such fuels, you have to figure

out how to transport it. The solids are easy to handle, and the liquids and gases are more difficult to handle, but more sustainable.

The gases are now moving us towards the hydrogen economy. If you look at BP and Shell ads on TV today, they talk about what is “beyond petroleum.” They are talking about moving to hydrogen. When you look at the actual data in terms of global energy consumption of solids, liquids, and gases, it supports the idea that we are moving to a sustainable economy based on gas. This idea of moving towards gas is something that is very interesting to everyone in Northeast Asia.

We talked about LNG, and some of the practical aspects of LNG. Right now, there are roughly 150 LNG tanker ships in the world. Over the next three to five years, there will be 50 LNG tankers under construction. So the amount of transportation capacity will increase by over a third. As the transportation develops, a spot market in LNG will also develop. Therefore, LNG is going to become a more viable form of energy than it has been in the past. In the past, it has all been driven by term markets—mainly in Korea or Japan, the two primary consumers. As you move forward, you will have more ability to be responsive to your short-term needs using LNG.

Another real issue we have spoken about is the influence, or dominance, of political interactions between countries. Back in 1993, Indonesia supplied over 90 percent of the LNG to South Korea. What happened in 2000 and 2001, when they had a political crisis in Indonesia? They declared that they could not supply South Korea’s growing demand. What did the Koreans do? They said, “That is fine. We will go find somebody else.” They did. Indonesia lost market share, and that is market share they cannot get back without doing it based on price and economics. Now Russia, as well as other energy suppliers, has realized that these markets are not as indestructible as was once believed. There is competition within these markets, and we believe the competition in terms of the demand side is very real and is going to drive a lot of what happens in Northeast Asia.

We have heard a lot of talk about various pipelines. There is a lot of talk about where the pipelines are going to go, how they are going to be routed, and various things like this. We

Figure 19. DPRK Electricity Generation by Fuel

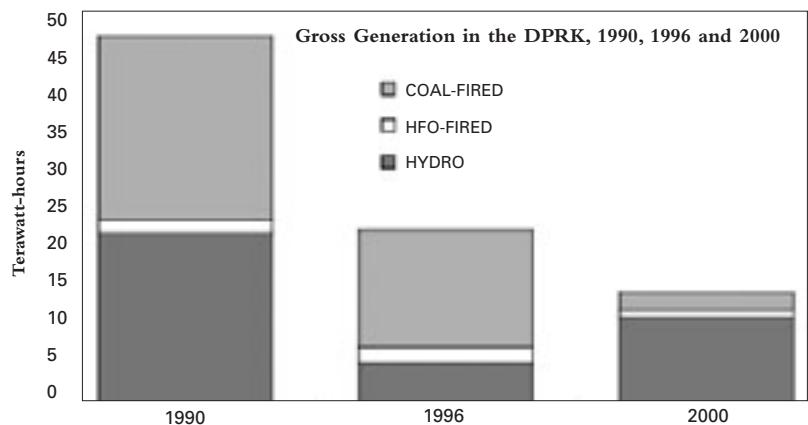


Figure 20. 2002 Energy Consumption by Country

| | Oil | Coal | Gas | (Units TOE) | |
|---------------|-------|-------|-------|-------------|-------|
| | | | | Total | (%) |
| US | 894 | 554 | 601 | 2,049 | 25.0 |
| China | 246 | 663 | 27 | 936 | 11.4 |
| Russia | 123 | 99 | 350 | 572 | 7.0 |
| Japan | 243 | 105 | 70 | 418 | 5.1 |
| Korea | 105 | 49 | 24 | 178 | 2.2 |
| Other | 1,912 | 928 | 1,210 | 4,050 | 49.3 |
| Total | 3,523 | 2,398 | 2,282 | 8,203 | 100.0 |

heard that there was a difference of opinion between Transneft and YUKOS about whether the pipeline would go to Daqing or to Nakhodka. I am a pretty simple guy. I am a businessman, and my question is—how does it work? YUKOS is a private company, and the government owns Transneft. We are talking about Russia—I will leave it there.

The end result is that we come back to energy consumption in the region, shown in **Figure 20**. I included the United States on this chart because the United States has been the elephant in terms of energy consumption in the world, but China has been non-trivial and has the potential to grow much faster.

Gas consumption in China is trivial compared to their overall energy consumption—a little over 1 percent. As we heard before, coal is king. When you compare China versus South

Korea, China consumes five times more energy than South Korea, but virtually the same amount of gas. Chinese gas consumption is going to rise; there is no doubt about it. The question is who is going to supply it and how that is going to happen.

There are two proposals right now in terms of how to supply South Korea, North Korea, and the Russian Far East with natural gas. One line comes from Kovykta down through Irkutsk, down through Dalian and over into South Korea. By the way, there are a few mountain ranges in between that add a little excitement to this route. The other line comes from Sakhalin down through an existing pipeline right away to Khabarovsk, down to Vladivostok, then down through North Korea into South Korea. In fact, a small part of this pipeline is being built already. Last week, President Putin was quoted in the *Novosti* Russian news service as saying that Russia is looking to extend the pipeline from Vladivostok into North Korea, whether or not the United States is in support. The Russians are basically saying, "Whether or not the United States is on board, we plan to reintegrate with our neighbors in Northeast Asia. It is going to happen." They have these two different pipelines with two different options, but vastly different levels of feasibility. Coming from Sakhalin, you must cover only half the distance that you need to from Irkutsk. You also have about 25 percent of the cost. I have heard estimates of the cost of the Kovykta pipeline ranging from \$11 to \$15 billion. Depending on how much you include in it, it is \$15 billion. Shawn McCormick probably has better numbers, and he said it was going to be \$18 billion.

We heard earlier that the Japanese are saying "this Nakhodka pipeline, as the cost estimates go up, the interest in it goes down." The same is true of the Dalian pipeline. Another aspect is, as I just told you, the demand for gas in China is going up. The question is, if you are building a pipeline from Russia and you want to come down here and serve China, where the demand for gas is going to grow at between 10 percent and 20 percent a year over the next 10 to 15 years, is why even look past Harbin or Xinjiang for where you are going to go with your gas? There is really no reason to. In addition to that, we heard about how the Transneft representative

and some of the government representatives in Russia have said they would rather have the pipeline in Russia as opposed to some other country. Well, you come over here to Khabarovsk, where Governor Ishaev has been in power for 20 years, both under the Soviets as well as under the Russian Federation, and he is strongly in favor of this pipeline coming over here to Khabarovsk and then going to China. If you have the government of Russia and BP saying different things about where the pipeline is going to go, I will argue the government of Russia is going to win at the end of the day.

Irkutsk can only supply a certain amount of gas to Korea under contract, and Korea's demand will far exceed that. This expandability and elasticity of the supply from Sakhalin is hugely attractive to the Korean government; to the KoRus Gas Company, a consortium of Korean, Russian, and U.S. owners; and to our partners, who are the power generating companies of South Korea.

We have heard from a number of people, including ExxonMobil and others, that there are risks associated with a pipeline through North Korea, which is absolutely true. Our response was that we would find one of the largest risk management firms in the world and say, "Can we address this risk in a way that is commercially viable?" The answer was yes. At the same time, we went to the financial community and said, "Can we finance this project?" As we heard before, the issue around the Irkutsk, the Kovykta, and the Nakhodka pipeline was—how are you going to finance this? Well, we come to the table with the financing in place, with commitments from commercially viable entities. What does it do for the world? Well, it is not only going to provide essential energy for North Korea, energy that would be available if and when the United States allows the Japanese and the Koreans to resolve the North Korean nuclear issue, and supply them with some energy. We have curtailed the KEDO (Korean Peninsula Energy Development Organization) project, which was the nuclear energy project set up to help North Korea in the 1990s. The only other option that is going to happen in a realistic timeframe is gas projects. Therefore, they need gas in North Korea. We cannot go around North Korea and still supply them; it is inconsistent.

By going through North Korea, which is the most economic route for the gas, you are able to pay the North Koreans for the use of that transit. The economic impact on North Korea would be roughly 10 percent of their gross domestic product today. It would have a huge impact on North Korea. All the North Koreans have asked regarding transit fees is, "Can we take that payment in gas? We need it in kind." This comes from a gentleman named Kim Kyung-Bong, who is the head of the North Korean Natural Gas Research Society. This is a country without natural gas, yet they have a natural gas research society so they know what to do with it if and when they get it.

For the South Koreans, it would provide fuel supply diversity. Right now, they are 100 percent supplied by LNG. They do not want to be. Right now, they have a fuel supply that is virtually inelastic. In the winter, when their gas consumption goes up for domestic and industrial uses, their response is to tell the electric generators, "You need to curtail because there is not enough gas." That is not an economically viable long-term strategy for developing your gas management program. A pipeline provides a somewhat more elastic supply. When you want more gas in the winter, you fire the compressors up a little harder, no big deal. It happens.

For the Russians, they would gain access to the Korean market, which they very definitely want. Shell is talking to Korea. ExxonMobil is talking to Korea. They are all looking for how to get to Korea. And finally, this whole approach would greatly enhance regional stability and regional security because, as Bismarck so accurately said years ago, "When commerce crosses borders, armies do not." South Korean gas consumption is going to grow significantly over the next 10 to 12 years, though not quite like China.

We have spoken a little bit about the regional strategy in terms of promoting interdependence. That is another critical piece in this equation. You are going to make the North Koreans an economic participant and they will develop an economy that, like it or not, depends on gas coming through North Korea. The gas is what is going to generate the economic engine for North Korea. The new employment will be from the Gaesong industrial park and the reinvigoration of the industrial sector in North Korea. If North Korea is depending on gas and

depending on their neighbors for their industrial and economic survival, the likelihood of their being in conflict with their neighbors is significantly diminished.

I will conclude by saying that Russia wants to participate in the Korean energy situation. They have made that clear. The South Koreans have made it clear that they want to reintegrate with North Korea economically and industrially. This re-engagement and mutual reliance is in *their* interest. The United States right now has a huge opportunity. The United States can embrace what all their neighbors are saying, and we heard how China wants to be more involved and exert their influence more. We have seen this in the six-party talks, where China has become the intermediary, if you will. They have hosted talks in Beijing. They are the ones that have talked to the North Koreans, then came back to the United States and said, "You need to start being reasonable." They have said to the United States, "You cannot be intransigent and expect a positive response."

Now here is the dilemma. Who is going to do anything for the next six months? Nobody. Because until the election in November, the North Koreans aren't going to move because they think that they might get a better deal from John Kerry. The United States is not going to move because there is not time to do anything. And so unfortunately, we are in sort of this interesting time warp, if you will, where we hear Shawn saying the Chinese are going to make decisions on where they are getting gas in the short term. And the United States is not going to make any decisions in the short term because there is going to be an election. And the North Koreans are not going to make a decision in the short term. So you have all these conflicting political motivations that unfortunately are overlaid on a very tenuous timeframe.

Discussion

ROBERT MANNING We have heard some very interesting presentations and some challenging remarks during the panel, and we should have an interesting discussion.

On some of the pipelines, I think Jim Dorian raised a key question. People have gotten way ahead of the fundamental reality, which is where is the oil? Long pipelines, like the one

If North Korea is depending on gas and depending on their neighbors for their industrial and economic survival, the likelihood of their being in conflict with their neighbors is significantly diminished.

in Nakhodka, tend to be really expensive. When you get a pipeline over 2,000 or 3,000 kilometers, it usually tends to make diminishing economic sense. So that is another element here.

I think another factor that was not touched upon is that of Russian policies and attitudes. With oil at \$40 a barrel, they are taking a very nationalistic state-managed approach to the energy sector. I am not sure they can pump out some of this oil that is being talked about without Western technology and investment. So there is another contradiction. Even if there is oil, it is not clear that it will be developed, and you heard about the lead times involved in terms of the discovery and production.

Nobody mentioned one other point, and that is the current contention over drilling in the East China Sea between China and Japan, which also involves a territorial dispute. So with that, let us take some questions.

Q. *I wanted to ask Mr. Fetter about the prospect of a gas pipeline coming from Sakhalin through North Korea into South Korea. Is this a choice between two pipelines, in other words, either the Kovykta line or the Sakhalin line? Or is there interest in building both? And then, about the route, if there is going to be a choice made between the Kovykta line and the Sakhalin line, I understand that the prospects of developing a Sakhalin line sooner are better because the Sakhalin production is up and running and the Vladivostok line is being built already. But it seems to me that recently, about a month or two ago, a trilateral commission involving China, Russia, and South Korea made a decision to run the Kovykta line, if it was built, through the Yellow Sea into South Korea, rather than going through North Korea. So that suggested a discomfort with running a line through North Korea. If, in fact, that discomfort exists, would those countries, in this case, Russia and South Korea, choose to make a decision to run the pipeline from Sakhalin through North Korea, rather than going with the Kovykta field, doesn't that show a real discomfort with dealing with North Korea?*

JOHN FETTER As I hear your question, it is really in three parts, and I will take them one at a time. The first being, is it a choice between gas from Kovykta and gas from Sakhalin? And our intent is not to posture the KoRus pipeline from Sakhalin and the Kovykta pipeline as competing with each other, because they do not necessari-

ly have to compete. The Irkutsk-Kovykta pipeline competes with itself in that the South Koreans, under any scenario, will only get a limited throughput capacity in that pipeline. Under any scenario, the South Koreans cannot get more than roughly their 7 to 10 billion cubic meters a year through that pipeline. That will take care of perhaps half of the growth in their demand between now and the time that pipeline comes online. Therefore, under any scenario, the Kovykta pipeline still requires that South Korea find something else to fill in the gap. It is not a choice between the two; South Korea would still require other gas supplies even with the Kovykta pipeline.

The KoRus pipeline as it is currently conceived could supply more gas to Korea, unless and until the Japanese are involved—and they have already expressed an interest in extending the KoRus pipeline from Pusan into southern Japan. A gentleman named Masahisa Naitoh, who is the head of the Institute for Energy Economics in Japan, basically pointed out the same thing that Mr. Ferguson did about the fact that all of the gas infrastructure in Japan exists in the southern third of the country. The northern two-thirds really has very little in terms of trunk line capacity and other infrastructure. Therefore, a pipeline coming over from Pusan to the southern part of Japan would make much more sense than one coming in from the north. If you end up putting half the KoRus volumes into Japan, you still need more gas for Korea, under any scenario.

Separately, if the North Korean economy grows, as we think it would if, as part of the resolution of the security issues, it were to receive the 2,000 megawatts of electric power that were promised in 1994 by President Clinton, then you would need several billion cubic meters of gas a year for electric generation in the North to provide that promised power. All of that KoRus capacity may not be available to North Korea, but there would be a great deal more flexibility in terms of planning for the South Koreans using the Sakhalin line, which they control, as opposed to using the Chinese line, where they are on the tail end of it and would get the remaining gas.

You mentioned the discomfort with the North Koreans. It is the 800-pound gorilla in the corner of the room—you cannot ignore it. It is very real. As Bob has said, we are hoping

that there is some movement between the United States and North Korea. All indications I have seen are that there is certainly more ability to discuss the differences between them. Whether or not they have yet reached a point where the gap is bridgeable is not clear. But the Japanese and the South Koreans, who are going to fund this whole thing anyway, have gotten to the point where they have said, "We need to move forward because we live here. It is much easier for you; you are 5,000 miles away. But we live here and we need to resolve this whole thing." On my last trip to Korea—or the second-to-last trip to Korea—I was playing golf at a course just about two miles from the DMZ, and from various greens you could see into North Korea. When you are in that sort of proximity to North Korea, it is much less simple for you to ignore them. And therefore, a solution becomes necessary.

And finally, I will say that, in terms of risk mitigation, the South Koreans view their economic integration with North Korea as intelligent risk mitigation. They believe that moving into Gaesong and developing industrial capacity and interactions with the North is intelligent risk mitigation. From a pipeline standpoint, from our business standpoint, the people we are working with in the insurance and risk mitigation side of the world have said we need to have a Plan B; we need to have an alternative strategy. And the obvious alternative strategy is to run two pipelines from Vladivostok—one under the sea and one through North Korea—where you split the capacity, so that all of a sudden, Kim Jung Il doesn't have a guillotine effect on the capacity of the pipeline. He has a diminishing effect, where he can only cut off half the supply. That may well be the final configuration, but that is going to be a political decision. That is not an economic decision.

But, the risk mitigation strategy that we have put in place that we have developed has various scenarios that allow us to provide alternative strategies as we move forward. I hope that answered your question.

Q. *I have an observation and a question. The observation comes back to a question yesterday about Gazprom and Sakhalin-2, and then Jim Dorian's comments this morning. Given Gazprom's charge to coordinate Russia's gas exports to Northeast Asia, per-*

haps the reason that Gazprom needs to be in Sakhalin-2 is that Moscow may not be comfortable with Sakhalin Energy, which at the moment has no Russian involvement, being responsible for delivering the first Russian gas to China. So it may be a question of face at the end of the day. But if Moscow wants to allow Sakhalin-2 to do this, the price may be that Gazprom has to be a partner because of Gazprom's mission. So it comes back to the leverage. It is access to markets and an agreement from the Kremlin.

My question is to John Fetter. When I raised the Trans-Korean pipeline with ExxonMobil about three years ago, and when they finally got back to me with an answer, they basically said, "There is no interest in Washington." That was the answer that they gave me. But my question really is where's the gas? What is a pipeline project without a gas project? ExxonMobil has not committed to the gas phase of its project. The early gas that is coming and has been signed up to deliver to the Russian mainland is from the Chaivo field. It is relatively modest, some of it will be re-injected into the well, and the rest is only going to supply local needs.

The gas phase, Phase 2, has not been committed to, and it is the gas phase that will deliver the reserves that you need. So they are not in place. Moscow may say, "We want to deliver this gas." But then why have they done what they have done to ExxonMobil over in Kirinsky? You would want ExxonMobil on your side to move ahead with the second phase of the project. I cannot see a commitment at present. There certainly has been a change in view over the last 12 months, where at one point they were saying the market conditions were not right and the gas phase was to be delayed at least until the end of the decade. The last official announcement I think was they would "reassess the gas market." But there is no gas to put in the pipeline. I would agree that this is a great project, you know, technically and economically. But politically, as you've identified, the risks are great.

It does raise a question, as does the first observation, about what role multinationals play in these processes, and how multinationals align with state interests, and whether or not in fact Moscow is not only uncomfortable with YUKOS being seen to drive Russian foreign policy, but equally uncomfortable with Shell and ExxonMobil doing it.

JOHN FETTER I will first make a comment on your observation, and I do this with great trepidation knowing that we have people from the Russian Embassy in the audience as well, who

may differ with my opinion. I would hope that my perception is accurate. Gazprom is far more concerned with being a part of any gas export by pipeline than I believe they are in LNG. LNG is something that is basically foreign to Gazprom and has not yet been something that they have incorporated into their long-term strategy. Therefore, I think that their opposition to anything that Shell might do or to Sakhalin-2 would be less vocal.

In terms of the gas being available, I can only say that our partners and we are in ongoing discussions with John Lee, who is the Country Head of ExxonMobil in Korea. You have to understand—ExxonMobil has some conflicting interests as well. They have interests in the Qatar trains of LNG coming to South Korea, but they also have vast amounts of gas in Sakhalin. And not only does ExxonMobil have vast amounts of gas in Sakhalin, so does ONGC Videsh, so does Rosneft, so do other people who have expressed very distinct interest in gas exports. In my discussions with senior people at Gazprom a couple months ago, their comment about “where would gas come from,” whether it would be Rosneft or someone else, was that “we will take care of that, that is our issue.” And they did not seem the least bit concerned about locating gas for their participation. In fact, two years ago, at the U.S.-Russian Energy Summit in Houston, Dr. Ryazanov, who is now Deputy Chairman of Gazprom, came over and made a presentation on Gazprom’s strategy. And there was this big, blue arrow coming down from Sakhalin to Korea. And I spoke to him, and I said, “But you have no gas in Sakhalin. How is this part of your strategy?” He says, “It will be part of our strategy.” He did not feel a need to expand on that.

So, the end result is we are in discussions with a number of different people. But, as ExxonMobil has said to us very pointedly, up to the most senior people at ExxonMobil, they are very definitely looking for markets. We have spoken to the head of ExxonMobil Russia, and they are definitely looking for markets for their gas in Sakhalin, and the only reason that things have not been developed is because you do not develop a field until you have a place to put it. You do not spend money developing a project that you have no use for, which is exactly why Sakhalin-3, -4, and -5 aren’t being developed. Because until you have a place to put it, why spend the money on developing it?

Q. *I’d like to direct my question to Mr. Ferguson concerning the geopolitical relations between Russia and Japan. You mentioned Prime Minister Hashimoto and President Yeltsin probably got along pretty well in trying to resolve the territorial dispute. What is the current status or future prospect of this territorial dispute between Russia and Japan, whether these two islands can be returned to Japan? If it is possible, then how does President Putin’s relationship with Prime Minister Koizumi today play out in terms of resolving these territorial issues in Northern Japan?*

JOSEPH FERGUSON Thank you for the question. The status in the Northern Territories is status quo. There has been some talk, as you probably are no doubt aware. You probably know about this issue better than I do, but there is a slight change within the Japanese Foreign Ministry (MOFA) in terms of how they were looking at the Northern Territories issue. This was in the late 1990s. The Russia School within the Foreign Ministry, the group of diplomats that dealt with Russia, had been a very unified school within the Foreign Ministry throughout the Cold War. The Foreign Ministry had increasingly less influence on Japanese policymaking, but this is the one area—policy with the Soviet Union and Russia—where they were dominant. They formulated all policy and all policy started and ended with them. But after the Cold War the influence of the Foreign Ministry in all areas declined, except perhaps in the sphere of relations with Russia. This made the MOFA all the more eager to maintain a hold on Russia policy, since they no longer had much clout over U.S. policy, or policy towards China and the rest of Asia. They have proven very intransigent about Russia and the territorial dispute, and this issue continues to dog the relationship. Putin’s relationship with Koizumi is cordial, nothing more. It is nothing like the relationship between Yeltsin and Hashimoto. One thing I should also point out is that after the 1996 election, many Japanese assumed that Yeltsin had firm control and would have the confidence to perhaps return some territory. The same sort of analysis is seen today, although it is a fallacy to think that anything will happen. It was a mistaken assumption in 1996 and it is a mistaken assumption in 2004.

Q. *I am seeking a little bit more clarity from Mr. Fetter’s presentation. Throughout your presentation,*

you seem to be intimating some things, but you sort of left me guessing as to exactly what those were.

For example, you made the statement that Russia is prepared to start providing energy assistance to North Korea, regardless of what the United States does. After hearing that, my initial reaction is “so what?” If they can find a way to profitably provide energy assistance to North Korea, why not let them go ahead and do that? What tie-in does that have to what we are doing in the United States? But, I am wondering, were you intimating something else? Were you intimating that perhaps we were preventing this plan from going forward? Were you intimating that they were not following through on this because of some sort of lack of progress in the six-party talks? Were you intimating that maybe we should be subsidizing some sort of energy assistance in the North Korea?

JOHN FETTER First of all, what I said was that the news in the Novosti Russian news service was that Russia was proposing to extend the pipeline from Vladivostok into North Korea. In the news piece from Moscow, it said “regardless of other countries’ involvement.” So that was not I saying that, that was the Russian news agencies. I was not meaning to intimate that the United States would oppose Russia being involved with North Korea because, in fact, the refineries in Najin and Sonbong and places like these have been supplied with Russian oil for years. So it is not a matter of the United States intervening. It is a matter of would we interrupt existing commerce? And the answer is I doubt it.

But, from your other point, does the lack of progress in the six-party talks affect our allies in Northeast Asia? I would say unconditionally yes. What goes on and what happens back and forth is certainly affected by the U.S. position, but it is not driven by the U.S. position. There are ministerial talks between North and South Korea on a weekly or a monthly basis. Hyundai Asan has ongoing commerce, as does KOLAND, which is a South Korean government entity, in North Korea. There are ongoing interactions that may not be wholeheartedly supported by the U.S. government at this point in time, but they are taking place and the United States is not prohibiting or preventing that.

Could the integration of North Korea into Northeast Asia be done painlessly and without cost to the United States? I believe the answer is yes. I believe that our allies in Japan, Russia, and

South Korea would all benefit by the United States listening more to the positions of North Korea’s neighbors. I believe they have listened to China in terms of how their posture has changed in the six-party talks. But at the same time, as Bob Manning is quick to point out, there are some significant impediments to this whole thing moving forward. There are human rights issues, and there are other issues. But, you know, there are human rights issues in China, and we still seem to be able to work with them and move forward. There were human rights issues in Vietnam, but we are still moving forward. There is a need for us to pick one issue at a time and move forward sequentially. And as the South Koreans have proposed in saying, “We would like to do something in a step-by-step mode,” as Congressman Weldon proposed upon his return from North Korea about a year ago, there needs to be a step-wise plan of “we will do this, you will do that. Then, if both of those are successful, you will do this and we will do that.” And I believe that could promote progress.

Q. We know the competition between China and Japan for energy supply has been gaining a lot of intensity over the past few years, particularly in the efforts to win Russia’s pipeline, and also over territorial confrontation in the Eastern China Sea. Some people worried about the two sides falling into military conflicts because of that. How do you evaluate the risk of the military conflicts? Thank you.

JAMES DORIAN I will not assess the risk of military conflict, directly at least. But, as I tried to point out in my talk, China’s energy consumption growth is rising rapidly. The government of China desires a doubling of GDP over the next 10 years. If China continues on even a modest pace of economic growth, let’s say in the order of 6 percent per year to 2020, the increase in energy consumption to that year will just be phenomenal. So this raises several questions. Where will China receive all of these new additional energy supplies? As I pointed out, China is counting on Russia to supply oil as well as gas to its borders and beyond. I think I made it clear that I am very pessimistic regarding the oil pipeline proposals to either Nakhodka or Daqing. The oil has to be in place in an economically recoverable manner to support either of these pipelines. So, until I see

evidence that these reserves are in place, China is not likely to receive its oil from Russia, in the near term at least.

So we have to pay attention to what happens in China over the next several years in terms of whether or not these potential energy bottlenecks—beyond oil and gas, you have serious bottlenecks with coal—whether or not these potential bottlenecks start affecting the economy of China, and then how, in turn, the government of China may respond to that. That is where you can get into all of these alternative scenarios, including military ones. Will it seek energy from other suppliers outside of Russia, Central Asia? Will it continue to go towards the Middle East, interested in gas in Saudi Arabia, for example? Iran is out there, West Africa. So, I think to answer your question in an indirect manner, we all need to pay attention to what happens in China over the next several years in terms of how the government responds to this growing thirst for energy, and what happens when oil is not forthcoming from Russia, for example.

JOSEPH FERGUSON I will add one quick point. I think that the competition between Japan and China reflects not so much the potential for future military conflicts, but the mentality that I alluded to earlier that still exists among a lot of governments in Asia that sources of energy are chips to be competed over and to be acquired, and that any gain by your economic competitor is a loss to you. I think the East China Sea, more than anything, really reflects that the Japanese have been very zealous, and the Chinese as well, obviously. But there has been talk of perhaps jointly developing what resources may be down there—we do not really know what is down there. I think it really reflects the kind of competitive mentality that still exists there. I do not know how much longer this mentality will exist and when they will get around to looking to the market, the international market, to resolve their shortage problems.

Armed conflict, there could be incidents, sure. Japanese fighters from Okinawa scramble very often to go intercept what they say are Chinese violations of airspace, and the same with the Japanese Coast Guard. There could be incidents, for example, like the downing of the P-3 down in the South China Sea off of Hainan Island. There could be incidents like that. But I

think full-born military conflicts in the near future are really unthinkable for everyone involved there.

JOHN FETTER In terms of military conflict and such things, I think the comment that was made this morning about there being rivalries among these different countries is hugely understated. The rivalries between Japan and Korea and China and North Korea and Russia, they are huge. Whether it was last year in the World Cup matches or in things like this, the rivalries play out on every level of society. At the same time, on a positive note, last year, during crab fishing season, the North Koreans and the South Koreans shot each other over fishing for Blue Crabs, and there were people killed crossing the line in the waters off North or South Korea, depending who you are talking to, on their west coast. This year, the two militaries agreed to have a common frequency on which they would communicate to avoid exactly that sort of problem. So some of these conflicts and some of these challenges are being resolved by these people in ways that may not seem huge to us, but they are very historic to the participants—in this case, North and South Korea—because they are cooperating in ways that demonstrate that they want to avoid conflict.

JAMES DORIAN I might add one quick comment. China is planning to build a strategic petroleum reserve, much like ours in this country. And they are looking towards enhancing their own energy security by doing this. It is still unclear as to where the financing would come from and who specifically would be responsible for holding these oil reserves in China—CNPC, for example, or Sinopec, or the government itself. But China is certainly taking steps to enhance energy security, and this is one measure that was recently announced. We will have to see what happens over the next several months, if not years, towards this end.

ROBERT MANNING Let me build on that briefly. There is a lot of talk about competition and military conflict. All the numbers that I have seen suggest that there is plenty of oil and gas at least for the next generation or two. I am not sure that anybody is actually competing in the sense of a zero sum. I think the more oil and gas

there is on the market, the more everybody benefits in terms of supply and price. I think the challenge is on energy security in Asia, and I think that many in the region have been slow to come to realize this. If you think of where we were in the 1970s, dependent on imported oil, that is roughly where China is now. They have been very slow in building a strategic petroleum reserve, which was the Western response. There is not anything like that in Asia. There has been a lot of discussion within APEC. There is a working group on energy security, which I have been involved in it a little bit, and that is one of the issues being discussed. And I would also comment that the short-term problem is possible disruptions of supply and price spikes. And the answer to that is not military. China could go out and build 25 aircraft carriers, and if something happens in Saudi Arabia and production stops, they would be in the same boat we are. We are all going to be in gas lines.

So what gets you energy security, and what doesn't? I think there is more to be gained with a cooperative system. In terms of in East Asia, only Japan and South Korea have any significant strategic petroleum reserves. China has talked about it, but they are haggling over who is going to pay for it. India has talked about it, but they have not really made a big decision to move on it yet. In ASEAN, several countries have talked about it but have not done much. So it seems to me that is the near-term response.

The one thing no one has talked about is technology, because if you are looking in the out-years—say, about 2020, 2025—if we are lucky, we will begin to see a transition. You

have seen hybrid cars starting to gain popularity. I view that as a kind of a transition technology. And again, there is the demand. There are two things about demand in energy. One, demand in Asia is going to outstrip the rest of the world by an order of two or three in magnitude. And number two; most of the increase in demand is going to be in the transportation sector. One thing the President has done has been to make a big push on trying to develop hydrogen and move to a hydrogen economy.

I worked at the Department of Energy. We held a summit last November and organized an international coalition, which included China, India, Korea, Japan, along with Europe and Russia, to collaborate on accelerating the research and development of codes, regulations, and standards to move to globally. The vision that the President has articulated is to try in the future to have the first car purchased by a kid that is born today be a hydrogen car. That is ambitious, but I do not think it is beyond the pale. Long-term energy technology applies to coal; there is a lot of research and development being done on clean coal technology. That also gets to climate change. There are also efforts to develop technologies to capture emissions before they go in the atmosphere, and possibly also to produce hydrogen from that.

Those kinds of technological developments will be a factor if you are looking out a generation from now, which is certainly unusual for people in government, but something I have managed to find the time to do. I will just throw out that idea on the role of technology versus long-term energy security.

Integration vs. Isolation—Northeast Asia's Approach to Russia

Panel 4

GILBERT ROZMAN I have responded to the end of the Cold War by focusing on regionalism. Beginning in 1992, I have been investigating the ways Northeast Asia is taking shape. I had looked at, in the 1980s, Soviet debates on China, Chinese debates on the Soviet Union, and Japanese debates on the Gorbachev Era. I thought this would be a chance to put things together to examine how the region was changing fundamentally.

Instead of finishing it in a few years, I took 12 years. I found so many component parts to the overall project that I ended up writing articles on specific themes—a number of them on the Russian Far East; Russian Far East ties with Japan and China; and how the Russian Far East was viewed from Northeast China and from the seacoast of Japan. The issues kept expanding. My book has tried to bring together the overall sense of what happened, and I will summarize a few of the themes focusing specifically on the Russian Far East. I also have just been traveling. I spent five of the last seven or eight weeks in Northeast China, Beijing, Vladivostok, Seoul, and in parts of Japan, including Hokkaido, again getting new perspectives. I see dramatic changes, but fundamental problems persisting.

In other words, this is a story of 18 years of maneuvering over what the shape of Northeast Asia should be. And during this period, commencing with Gorbachev's Vladivostok speech and the "new thinking" in the Soviet Union, I detected six stages.

What I see is Washington and Moscow—the two dominant voices in the post-war era—becoming less dominant, and Beijing and Tokyo rising to try to take some control of the region. Each in turn has had strategies for shaping the region, looking to different areas in particular where there seems to be a vacuum or an opportunity for contestation. I see them working in the context of Moscow, especially for the Russian Far East, and Washington, and also, in recent years, the Korean Peninsula.

Along the coast of the Western Pacific, there are four areas that seem to face the most uncertain prospects. Southeast Asia has become a

zone of competition between China and Japan through ASEAN+3. Taiwan is becoming more of an interest to Japan, and the United States and China, of course, have been differing over its future. The Korean Peninsula has become of late the primary locus of struggle—not just over the nuclear crisis, but also over prospects for a longer-term evolution and reintegration. But the Russian Far East should not be ignored in this process, despite its small population. The tendency, when we think of trade or FDI, is to say, "Well, this area really doesn't count for much." The rest of Northeast Asia, except for North Korea, has skyrocketed in economic integration from trade figures that were on the order of \$50 billion 15 years ago, to figures that are now heading towards \$300 billion, with foreign direct investment likewise accelerated. At the same time, the Russian Far East has not done particularly well, particularly after the early 1990s, in trade and investment ties, except for Sakhalin-1 and 2.

Viewing this from the different angles of the cities on the border and the national capitals, we see different expectations for what should be done and what the prospects are for the Russian Far East. I see a struggle over regional influence in which economics plays an important role—everybody is looking for further economic advantage here—but not a dominant role. Even though energy has been the angle we have looked at today, and that is natural, from the Russian side, they actually keep talking about other forms of economic ties to make them more confident of their participation in this region. They do not want to rely on energy alone, and they are looking for others to help them come up with a different approach beyond energy.

Security, of course, is a big issue. I do not think our usual interpretations of national security or realist thinking deal with the complexities here, with what Bob Sutter this morning called "the pervasive hedging" that introduces so many different ways of dealing with security. Beyond that, there is a real uncertainty about the national strategies and identities of these

countries that are in Asia, and about the role of identity. Japan is trying to get beyond its Western-type identity that prevailed in the Cold War era; China is reasserting its place in Asia in a return to its historic role as a central country; Russia is trying to claim a place in the area; Korea is overcoming what it considers a series of dependencies to strike out with some degree of flexibility in foreign policy. So everybody is looking for a way to incorporate their own sense of their national pride in organizing this region.

In the first stage, from the late 1980s to at least 1993, the Russian Far East was seen as the new frontier. The Japan strategy was discussed as “The Japan Sea Economic Rim,” as a plan to persuade the localities in the region through sister-city arrangements, humanitarian aid, and promises of investment that Japan was the ideal partner for Russia. Japan was optimistic at this time that its extraordinary economic advantage in the region would be convincing. But it did not prevail. It emphasized the territorial issue, which delayed national relations and frightened local ties. Its boosters in the areas of Japan bordering the sea did not emphasize modern market ties sufficiently. They did not know very much about the Russian Far East partners that they were trying to deal with. And I think this only led to a criminalization, particularly the crabs-for-used-cars trade, and a lack of seriousness in pursuing things further.

China emphasized an open border. It also tried to pick off the Russian Far East, in a way, from Moscow, as the Russian Far East was losing its transportation and energy subsidies. It tried to foster a kind of border fever to forge networks of trade and joint venture businesses, including shuttle traders. But I think that this proved very disconcerting for the Russians, particularly as these were non-modern elements of China, and there was a lot of fear of Chinese domination. Even though the Chinese handled the territorial issue more positively, for the first decade, at least, they had trouble with both the leadership in Vladivostok and in Khabarovsk, who were worried about what the territorial situation would be.

The result of this first period was not an improvement in regional trust, but only a temporary jump in cross-border trade, mainly on the Chinese border. There was an intensification and criminalization of efforts to make quick

money, a focus on border deception, and a kind of economic crash along the border in 1994. They really have not fully recovered from that period. South Korea was also engaged, in a secondary way with its “Nord Politik,” trying to reach out to the Russian Far East, but mainly with the goal of dealing with North Korea.

Moving to the next stages, we find a kind of marginalization of the Russian Far East. Seen as a crisis area, not much could be accomplished. Economic integration elsewhere in the region was advancing rapidly during this period. This is when China’s economic growth was its fastest, and South Korea–China and Japan–China ties were advancing very well along with the economy. But the Russian Far East was not going forward very much. Both China and Japan were still thinking about this area, but in more of an effort to stabilize it than an effort to really move forward substantially on integration. At this point, they moved more through the national capitals in their efforts to deal with these areas. In the case of China, they build up a strategic partnership through Moscow, and kept talking about bringing the border areas, which were much further behind in ties and had much more distrust, into a civilized relationship where there would no longer be the chaos on the border. But they had very little success and trade did not really pick up until the beginning of this decade.

In the case of Japan, they came up with a program built on a countdown to the year 2000 in an effort to try to build up national ties focusing primarily on the territorial solution. Ultimately, by the end of 1998 and 1999, both China and Japan were disappointed that they had not achieved much success. They had trouble with some of the Governors in the RFE. They had to try to bypass Governor Nazdratenko of Primorye, because he was not really encouraging ties across the border. China had to be very patient with Governor Ishaev in Khabarovsk, because he is very suspicious of them. Japan had to emphasize energy to try to reorient Governor Farkhutdinov in Sakhalin. Those are the areas that matter most in this Sino-Japanese rivalry. Perhaps, some territorial reorganization is likely to occur in the Russian Far East, as some effort is made to reduce the 89 regions of Russia. Until now, however, all three of these areas were problematic in this period for building better relations.

Next we move to the next two stages, which really center more on Korea with the Sunshine Policy and the nuclear crisis. And here we find the leadership in Moscow beginning to think more strategically, and to look for ways of dealing with this region that will be of a more long-term nature. They were perhaps thinking of the Russian Far East along a vertical axis reaching down through the Koreas, trying to achieve balance with North and South Korea, and trying to build long-term mega-projects—railroad and pipeline. And we see the city of Pusan in South Korea emerging as a kind of transit point between both China and Japan, and the maritime Russian Far East.

During this period, China recognizes that Putin's strategy is more concerned about the long-term and that there is Russian worry about the rising status of China and its potential to dominate the Russian Far East. I think China then becomes more and more patient and tries to figure out how to reach Russia for long-term purposes. It does succeed in trade, to a good extent. Trade increases rapidly. There is more of an effort to develop regional partnerships. There is more Sino-Russian coordination, for instance, dealing with North Korea. Though there are limits to how far China can go, they keep going further. And I think they are getting ready for a new stage of development, which I will describe in a moment.

In the case of Japan, they met an impasse when they decided, for internal reasons, that they were taking the wrong diplomatic approach towards Russia. While Japan was making progress with Russia, they abandoned the negotiations, and then had nothing to go forward with. Relations were at a standstill. So, suddenly, on the eve of a visit to Russia, Koizumi had to come up with something new, and the oil pipeline comes forward. I do not think it was well thought-out. I do not think there is a lot of business interest in Japan. Yet, energy has breathed some new hope into relations.

There are different reasons why this is seen as a new theme—partly as an effort to counter China and maybe develop some kind of limit on China's growing leverage in the region. There was some concern about energy. Part of it seems to have been, especially for some people who supported it, some kind of bait to get

Russia back into Japanese ties in order for Japan to bring up the island issue once Putin was re-elected. The Islands would still be a pre-condition for going forward with massive projects. There is also some strategic long-term thinking in Japan that says they really ought to establish a closer relationship with Russia as part of a way of dealing with their re-entry into Asia and for dealing with the Korean situation. So, now we have reached a point where the uncertainty of the North Korea situation is beginning to ease a little. Countries are beginning to say, "Well, where are we going after the nuclear crisis is resolved?"—without, of course, any certainty that that will happen.

And here I see another stage emerging. We have a new set of summits coming up. President Roh, who is the champion of regionalism now and bringing Russia into the process again, goes to Moscow in September. Putin goes to Beijing in October. Putin goes to Tokyo at the beginning of the next year. And for each of these meetings, there are themes that are being discussed that relate to the future—the future of the Korean Peninsula; the future of large-scale projects; and thinking about how to build relations on a longer-term basis.

I think the Chinese have gone furthest in this type of thinking, and I think they may make the most progress. At least, they are confident they are going to make a lot of progress at the October summit on the remaining territorial disputes between China and Russia, because they have already been able to allay Ishaev's fears. There has already been a good deal of progress in Khabarovsk's relations with Heilongjiang and elsewhere in China, as seen in the June investment conference in Khabarovsk that featured a high-level delegation. There has been progress in consolidating economic relations, building on the 2001 treaty between the two countries and making the strategic partnership more serious. But the Chinese understand the limits these days, and they realize that Putin is still looking for balance. So what we really have to ask is who is offering Putin a more balanced long-term approach in terms of the outcome of the Korean Peninsula, or in terms of better relations with Japan?

I am not sure that the Japanese will be prepared to do so. They have not, I think, made up their minds on how to deal with the summit

If the U.S. position is regionalism is threatening to the U.S. traditional hub-and-spokes approach, then I think we become isolated, because the forces for regionalism still are growing, despite the various tensions in the area.

early next year. Right now it looks like the territorial group that says, “Hold everything until we get progress, a breakthrough on the territorial issue, all four islands in a batch,” is gaining some strength after a petition was signed by 25 people of influence in January and after new discussions in Tokyo. I am waiting to see if Japan can deal more broadly with these issues, particularly as it now is trying to prepare for North Korean diplomacy in the next year or two.

Still, Russia is not prepared, based on what I saw during my recent visit to Vladivostok, for a regional strategy and for regional cooperation of a substantial sort. The criminalization in the region has not been slowed, and in fact, it is accelerating in Primorsky krai. The preparation for foreign direct investment is doubtful, as is evident in what is happening in the Vostochny Container Terminal and, as I see it, Sakhalin-3. There is no confidence that they are going to have much of an offer from Japan. There is not a serious discussion, from what I can tell, of some kind of compromise on the territorial issue. I do not see leadership coming from any side on how to forge some kind of regional ties that go beyond the problems of regionalism that have prevailed over the last 15 years. And in this next phase, the Sino-Japanese rivalry seems to be the dominant theme that would again suggest holding up regionalism, despite the enormous economic gains between China and Japan.

This rivalry is still being played out over the Russian Far East. The oil pipeline is a big theme. It is not clear that it is being played out with long-term calculations because of Japan’s confusion about its priorities. I would say that we do not know the answers to a lot of questions, and we are waiting for someone to step up and come up with a broader strategy for how to deal with this area. And what is the U.S. position? If the U.S. position is regionalism is threatening to the U.S. traditional hub-and-spokes approach, then I think we become isolated, because the forces for regionalism still are growing, despite the various tensions in the area. If the U.S. position, however, is that we can steer regionalism, then we can play a big role—because of Russia’s need to balance China; because of Japan’s great desire to be there and their concern about China; and because the Korean Peninsula needs a resolution that goes way beyond just dealing with the nuclear issue. In that case I think the United States has a real

opportunity to help shape where things will go. But first of all, we should help deliver a message to Russia that the rising nationalism and continued criminality make it very hard for anyone to look forward to a way in which this area can be incorporated into a broader Asia.

ELIZABETH WISHNICK In the past couple of days, we have heard a lot about how these large-scale energy projects in the region promise to provide a new impetus to integration and spillover effects that will promote domestic development. What I am going to do in my presentation is talk about the downside to regional integration, and to look at how regional integration may accentuate security challenges. Particularly, I am going to focus on the issue of migration, mostly looking at the case of Chinese migration to the Russian Far East, but I will also draw some parallels to Russian migration to Japan. I will then make some concluding points about criminality, and what I call dysfunctional integration.

We heard about these energy projects in the context of the development needs of the parties. I would like to point to one fact, and that is that lagging development in both the Russian Far East and the Chinese Northeast has been, in part, at the root of interest and cooperation in the energy sphere, as well as in other areas. This has been the case in terms of labor cooperation between China and the Russian Far East. The Chinese side has long viewed labor cooperation as particularly promising. But, for the Russian side, security concerns about the presence of Chinese migrant workers have prompted new measures to regulate cross-border activities in general, as well as caution with respect to undue dependence on the Chinese market for labor—in particular in the case of migration, but also in the energy sphere, as we have heard previously.

For the Russian Far East, the creation of these pipeline networks would help resolve domestic shortages, create a decreased cost of production, and anchor the region more firmly in the Asian economy. For China, there are also some domestic factors. We heard a little about them in James Dorian’s presentation this morning. China is seeking to maintain energy industries in an otherwise ailing northeastern region, which has been the locus of large-scale labor unrest in the past couple of years. Thus, China

has a domestic interest in terms of socioeconomic stability as well as a desire to secure additional energy supplies.

I want to make a few general points about globalization and regional protectionism before I move on to the migration case. The process of globalization transforms social relations and transactions by generating transcontinental or interregional flows and networks of activity, according to David Held's widely respected definition. But globalization has uneven distributive effects, and not all communities have the same degree of access or involvement in global networks. And so instead of promoting integration, globalization might also highlight regional disparities and accentuate areas of conflict between countries, leading to fragmentation as well as integration, or even to both simultaneously. Globalization may not even be the dominant force in a particular community. Localization may also take place or be stronger than the effects of globalization. For example, in the case of migration, global migration flows may not promote a global division of labor, but instead might prompt calls for protectionist economic measures by what James Rosenau has called "resistant locals," who have fears about the influx of these global flows.

I am going to talk to you primarily about my research over the past two years on Chinese migration to the Russian Far East. This was part of a multi-national project on migration flows in Northeast Asia. I have done some public opinion surveys of Chinese workers who have gone to the Russian Far East and then come back to China. I have been working with a Chinese colleague in Harbin to document Chinese reactions to their experiences in Russia, and to find out more about those Chinese who have come back to China. We know a lot about the Chinese who are in the Russian Far East at the moment. Most of the survey data has documented their experiences. But, as I will argue in a few minutes, these are a minority, and most of the Chinese who go to Russia return to China, so it is important to know why.

As we heard earlier in this conference, Russian concerns about Chinese illegal immigration are fueled by demographic pressure. The Russian Far East has a population of just 6.68 million, compared to a population of more than 100 million in the three northeastern provinces

in China. The Russian Far East has faced an outflow of population, although less so from the provinces and regions along the border with China. Primorsky krai saw a 1.5 percent decline in its population in the past decade. Khabarovsk krai saw a 3.3 percent decline. So this is much less of a decline than the other regions we heard about yesterday.

The problem has been very exaggerated press reports and statements by various political actors in Russia overstating the presence of Chinese migrants. There have been statements alleging several million Chinese are present in the Russian Far East, which is impossible. The population of Vladivostok was about 600,000. If there were millions of Chinese, if one went to Vladivostok, they would presumably be quite noticeable, but this has not been the case in my experience. In the most recent statement I have seen by a Russian official, Sergei Prikhodko, who is Putin's Deputy Chief of Administration, stated that there are probably no more than 200,000 Chinese present in Russia. And the regional data also seems to correspond with that. Primorsky krai's Interior Ministry reported that since 1997, 99 percent of the Chinese who enter the region return home to China, and this is compared to 64 percent in the mid-1990s. So while 99 percent may be a slight exaggeration, the trend seems to be a regulation of the presence of Chinese on Russian territory. It also points to the fact that the presence of Chinese in the Russian Far East is relatively small. While Russia is a country that is a recipient of migrants, most of them are not from China—they are from other CIS countries. Russia received 13 million migrants in 2002, but these were mostly from the CIS, not from China.

Why do Chinese workers go to the Russian Far East? In my study, I have been looking at a variety of push and pull factors. Push factors have to do with underemployment and economic hardship in the Chinese Northeast. And most of the migrants from China to the Russian Far East are from the three northeastern provinces in China: 65 percent from Heilongjiang and another 10 to 25 percent from Jilin, and the rest coming from Liaoning, Shandong, and Jiangxi.

One thing we have to remember is that while the Chinese population in its Northeast seems very numerous in comparison to the Russian Far

The Russian Far East has a population of just 6.68 million, compared to a population of more than 100 million in the three northeastern provinces in China.

East, it is actually a relatively sparsely populated area when it is compared to the rest of China. At the same time, the Chinese Northeast receives a disproportionate share of poverty relief assistance because of adverse economic trends. These three provinces hold just 8 percent of China's population, but receive 22 percent of poverty relief. This is because of the widespread lay-offs from state-owned enterprises. They comprise twice the national average share of employment in the Chinese Northeast: 31 percent in Heilongjiang and Jilin, and 37 percent in Liaoning. This indicates a very serious unemployment problem from the state-owned sector.

As I mentioned, decreasing industrial employment has led to large-scale strikes. From March to April 2002, there were thousands of laid-off workers protesting in three northeastern cities, including Daqing, which would have been the end point for one variation of the pipeline. They were taking to the streets to protest non-payment of wages and benefits. Chinese leaders took this very seriously. After the strikes, the Premier Wen Jiabao visited Daqing and another city, Fuxun in Liaoning, and announced subsequently a new program to assist Northeast China, targeting key industrial sectors. When you think about Chinese interest in these pipelines, we have to keep in mind the social component: that there is a tinderbox in Northeast China, and the Chinese leaders are trying to look at energy cooperation as a way of diffusing some of these potentially explosive tensions.

But there are also pull factors, and in my public opinion study, these have come out quite strongly. So far, I only have data from the first 150 respondents, and I am working with a colleague in Harbin on another 250 surveys. I should have them back in another couple of weeks. But this initial survey shows that the main reason why Chinese go to the Russian Far East to work is because they see greater opportunity there—42 percent of my respondents said that. The second most important reason was that they were sent by their work unit, according to 31 percent. And 19 percent claimed they were unemployed. Now clearly the pull factor is important.

We also have to keep in mind that the Chinese labor export to Russia is still relatively small. It represents just 3 percent of China's total labor exports. And China's northeastern

provinces, despite their big economic difficulties, are also relatively insignificant players in overall Chinese labor exports. It is really the southern provinces Fujian and Jiangxi that provide most of the labor that is exported worldwide. In 2003, for example, Heilongjiang sent a maximum of 5,000 workers to the Russian Far East, and the number of workers that Heilongjiang has been sending in the past decade has been falling by an average of 10 percent. So these are still relatively small numbers, at least of organized labor exchanges.

The problem has been that labor cooperation between China and Russia has not proceeded in the desired way. It has not facilitated economic integration. Instead, it has arisen as a source of conflict between the two countries, and this is a reflection of their different conceptions of the benefits or the costs of labor cooperation. The Chinese position is that labor cooperation is an economic issue. It is mutually beneficial, given Russia's labor shortage and China's oversupply. They do not use the term "migration." The Chinese talk about "labor exports" and "overseas workers." They never talk about migration.

The Russian position, on the other hand, is that the Chinese presence presents a threat because Chinese workers in Russia are potential migrants and not temporary workers. They see the Chinese workers as a threat in two respects to Russian society. One is the sense that Chinese migrants create transnational networks and create communities wherever they reside, in Moscow or the Far East, as they do all over the world. The creation of such communities, in the view of some Russians, creates a challenge to the "Russianness" of society by creating little enclaves of non-Russians and introducing other problems, such as criminality. Second, some Russians also see the presence of the Chinese as a threat to their economic security, meaning their ability to earn their livelihoods in their desired way. Russian survey data shows that this is particularly the case in the Russian Far East. According to a survey by Vilya Gelbras from Moscow University of Russians in Moscow, Khabarovsk, and Vladivostok in 2001, those Russians who had negative views of the presence of Chinese tended to believe that the Chinese lived better than they did. This was particularly strong in the Russian Far East. For example, 60 percent of respondents in

Vladivostok held this view and 56 percent in Khabarovsk, compared to 21 percent in Moscow, where incomes are higher.

What is created is, in effect, an economic security dilemma. Russians in the Russian Far East see the methods that the Chinese workers employ to improve their economic situation as a threat to their own livelihood. And so, as a result, there is less desire by the Russian side to participate in labor cooperation with the Chinese.

So what can be done to promote greater economic cooperation between Russia and China, especially in the labor area? Many in the Russian Far East claim that China has a policy to resettle its excess labor force in Russia. They see this as a further reason for caution in terms of cooperation with China in labor and in other areas. But in fact, in my research, I found just the opposite: not only is there no Chinese policy to resettle the Russian Far East, but China has no migration policy at all. The policy is very decentralized, and often implemented by non-state actors, such as provincial-level labor export agencies. The provinces have an incentive to turn a blind eye to any problems with these agencies, which are not regulated by the national government, so it is very difficult for Beijing to actually resolve these issues.

On the Russian side, there has been a focus on regulation. The Russians have re-imposed, in cooperation with the Chinese, visas for border crossing for business travel, and have recently issued quotas on foreign workers. Moscow, for example, set a quota of 15,000 foreign workers for Primorsky krai last year, even though the region might need more foreign workers. And this is a problem to keep in mind when thinking about how to carry out these big energy projects, because there are quotas set for all of the regions in terms of the import of labor.

The problem with these new regulations on the Russian side is that, due to corruption, many of them are not enforced. There is a new migration law that has set stricter procedures for entry. But where there is a new law, there is a way to circumvent that law. This had led to a criminalization of both legitimate business activities and tourism between the two countries. Chinese business people who are trying to go to Russia complain that it is so difficult to get a visa for business travel that they often have to resort to quasi-legal means, such as joining a

tour group and then leaving the tour group to go off and do their business.

And then there is criminal behavior. For example, both sides tolerate the promotion of sex tours for Chinese who visit the Russian Far East. You have criminal activity that is tolerated in the guise of tourism, and you have legitimate business activity that is criminalized because of procedures that obstruct business. And you also have the criminalization of contract work; because Chinese contract workers are often paid in goods, not in money. To take those goods to China, the workers need an export permit and to pay a customs duty. And so they would be taxed on their salary. To avoid that, the Chinese often sell their goods on the black market. Thus, you have contract work, which is regulated by law but becomes criminalized.

You have a concept for integration in terms of a mutually beneficial market—China's labor surplus and Russia's labor shortage—and efforts to create some synergy between them. But you also have all kinds of dysfunctional practices that result. This has had its impact on integration in general. The Chinese, as Gil mentioned, have been much more enthusiastic about the whole concept of regional integration. They see it as a win-win situation. Out of frustration with all of these bureaucratic problems, they have been taking matters into their own hands. For example, in January of this year, the Chinese expanded the free trade area at Heihe from Heihe Island to the City of Heihe, and they allow Russians to live there for up to 30 days visa-free and even to purchase real estate and cars. And this is not reciprocated on the Russian side. In Blagoveshensk, the Chinese do not have the same rights. But the Chinese decided their initiative would be beneficial, so they will open up further.

I heard in Harbin a couple of months ago that the Chinese are prepared to invest in the bridge between Heihu and Blagoveshensk—it is something we have heard about for more than 10 years. There was a problem—where would the funding come from on the Russia side? The Chinese said they would pay for the whole thing if they were reimbursed in tolls. The Chinese are trying to find a way, and the Russians have been much more cautious because of these security concerns that I mentioned. This has had an impact not just on the

You have a concept for integration in terms of a mutually beneficial market—China's labor surplus and Russia's labor shortage—and efforts to create some synergy between them. But you also have all kinds of dysfunctional practices that result.

regional level, but on the bilateral level, as we see in the WTO talks, where the opening of the Russian market to Chinese labor has been an issue of contention between the two sides.

I have been speaking about Chinese labor migration to Russia. But Russia is far from unique in Northeast Asia in terms of its resistance to opening its borders to labor migration. South Korea and Japan, for example, have similarly restrictive policies, and this is despite their own worker shortages. They have a similar attitude towards influxes of foreign workers out of concern for cultural homogeneity and their own work force. Russia, it should be pointed out, is not just a recipient of migrants; it is also a sender. Russian Far East residents also go to Northeast Asian countries to work, to seek better opportunities.

As part of the project I was involved with, some of my colleagues, Tsuneo Akaha and Anna Vassilieva, studied the Russians who go to Japan, and conducted surveys about their reception in Japan. It was an interesting comparison, because Japan is a country that has been an engine of integration in Asia. But, like Russia, it is a country with a relatively closed migration policy. Nonetheless, in 2002, 10,000 Russians went to Japan to work, including 5,000 in the so-called entertainment industry, which generally refers to the sex industry in Japan. And just like the Chinese in Russia, the Russians in Japan (as is the case for the Chinese and the Koreans in Japan) are the victims of widespread negative stereotyping and association with criminality. But Japanese entry restrictions are quite strict, and despite problems encountered by Russians working in the region, regional trade between the Russian Far East and along the Sea of Japan and Hokkaido has continued to be important.

To conclude, I want to mention that migration has often been linked to criminality. That has been another problem in terms of opening the region to labor cooperation. For example, Chinese migrants have often been associated with illegal trade, smuggling natural resources, and poaching. There is an interaction between the quasi-legal status of the migrants, corruption of the police who are supposed to be preventing illegal stays in Russia, and various forms of criminal activity. Integration can therefore be a double-edged sword. It can promise economic benefits, as we heard in the case of the ener-

gy projects and, as the Chinese like to talk about, in terms of labor cooperation. But it also involves transnational challenges that are very difficult to address.

For example, how do you open borders and promote integration without letting in massive numbers of migrants and facilitating criminal transactions? It presents a paradox. Integration requires lowering economic barriers, but it also involves enhancing regulations. But the big obstacle here is corruption, because if you pass laws to regulate migration or other forms of economic integration, you have to be able to enforce them. There are too many ways out, both on the Russian side and the Chinese side, which create incentives for criminal activity and engender a form of dysfunctional integration that both undercuts the regulatory efforts and decreases enthusiasm for the project of integration in general.

DANIEL PONEMAN I thought I would talk about nuclear weapons in Northeast Asia, and, obviously, Russia has a critical role in that whole story.

Nuclear weapons burst onto the world scene (since most of the world was unaware of the July 16, 1945 test at Alamogordo, New Mexico) in August of 1945, when, on two sultry days, the nuclear age dawned for the world. In preparing for this talk, it occurred to me, looking back, that nuclear weapons have not really strayed very far from center stage ever since. Of course, a few years later, we were engaged in the war in Korea, and President Eisenhower and Secretary of State Dulles hinted, suggested, insinuated, that nuclear weapons might be used against Korean and Chinese targets. They later said they believed that that implicit threat was a key factor in ending hostilities at that time. I am not just trying to get into hoary historical legend here. I think it is important to understand how deep and how far back some of these issues go to understand today some of the depth of the attachments and of the concerns that drive the whole nuclear weapons issue in Korea.

I think that Kim Il Sung always nursed an interest in nuclear weapons, probably dating to that time. We understand that he asked Chairman Mao for assistance in obtaining nuclear weapons, and was rebuffed by the Chinese; the Chinese having themselves tested a

nuclear device in October of 1964. I do not want to say nuclear weapons spread, because I think there is too much talk about infectious disease-like metaphors that really do not apply to nuclear weapons. I do think it is fair to say that there was a widespread interest in nuclear weapons throughout Asia at various points in time with various degrees of intensity.

In the 1950s and 1960s, you had the typical kind of sponsorship for nuclear energy programs that the Soviets used in the days of “Atoms for Peace” as a form of economic cooperation to enhance their ties to other nations. The Soviets did assist in North Korea’s nuclear program back then. By the time we roll around to the 1970s, you have a very different dynamic. By 1974, we witnessed the atomic blast in the Rajasthan Desert in India, and we had a very tough time keeping more countries from going nuclear. That was when I first starting working in non-proliferation, and we used to talk about the “dirty dozen” countries that we were worried about. We had a *very* tough time in those years with both South Korea and Taiwan. It took a lot of heavy leaning on the part of the United States in that era to keep South Korea and Taiwan from going further down the road toward nuclear weapons. We can talk about that, if you like, later in the course of the Q&A.

It is interesting, throughout this period, to take note of the dog that did not bark, and that was Japan. People often forget that when people worried about the problem of nuclear proliferation in the 1950s, the first countries that were listed were Germany and Japan. I do not think you can understand either the process of nuclear non-proliferation generally or those countries without thinking of the U.S. security role in both Europe and in Asia, and the critical role that the extended deterrent that the U.S. offered to its treaty allies played in giving them the reassurance that made them think that their security interests were best served by relying on that deterrent. By the way, it was that dependence which gave us adequate leverage to dissuade South Korea and Taiwan from continuing down the nuclear path in the 1970s.

The situation changed still further. By the time the 1980s rolled around, we had a stealthy North Korea nuclear program. They were building a large so-called research reactor, which we now know was actually a plutonium

production reactor. In the interest of time, I will use one word to summarize what the United States did about it—nothing. Years went by. Finally, the United States leaned on Russia, which by that time was interested in supplying North Korea—not with little IRT research reactors, but with large power stations fueled by nuclear energy. We said, “You really have to get the North Koreans to sign the Non-Proliferation Treaty.” That happened—in 1985, North Korea signed the Nuclear Non-Proliferation Treaty.

Of course, under the terms of the treaty, they were supposed to negotiate a safeguards agreement with the International Atomic Energy Agency (IAEA) within 18 months. About 17-and-a-half months into this 18-month period, North Korea sent word back to Vienna to the International Atomic Energy Agency that they had been sent the wrong safeguards form. And since, after all, all we are talking about are nuclear weapons, the Agency gave them an 18-month extension with no objection from the United States. That 18 months came and went with no safeguards agreement.

Now we come to the first Bush administration, and you had a facility that was starting to catch the notice of various officials in the United States and elsewhere. There was some debate whether it was some kind of vinylon factory, which is a nylon-like substance. That seemed odd to be collocated with a nuclear weapons facility. But it turned out it was a reprocessing plant. We now know that it produced some plutonium, which even the North Koreans have acknowledged that they had separated. I will spare you the details—you can buy the book, if you have the sufferance for it. We ended up negotiating in the 1990s a freeze on the plutonium program in North Korea.

I think it is important to note here that the Russian role in this was important. It was not always helpful, but by this time, the relationship between both China and Russia on the one side, and North Korea on the other, had evolved. Of course, both China and Russia had by this time both recognized South Korea. And by this time, there was at least a substantial hedging, if not an outright preference, in some respects, to deal with South Korea over North Korea.

In the case of China, the relationship remained very strongly one of sponsorship in

the sense, quite literally, of North Korea depending on China for food and fuel. In the case of Russia, it was a little different. In fact, South Korea's Kim Young Sam visited Moscow in 1994, and came back exultant that he had gotten the document that had the communications between Stalin and Kim Il Sung on the initiation of the Korean War. The Russians at that time basically indicated—and I cannot recall, frankly, the formality of this indication—that the promise that they had made in their Mutual Defense Treaty with North Korea to come to their aid in case of an attack was not something that the North Koreans could rely upon.

Again we come back to issues of proliferation that are embedded in the broader security relationships that the countries in the region have with the outside world, be it Russia and China on behalf of North Korea, or the United States with respect to South Korea and Japan.

We can look back and see that the role of the outside powers changed substantially over time. When you think historically, the United States began in the role of a brandisher of nuclear weapons in Northeast Asia and a potential threat and evolved, I think, into a much more benign role: (a) providing the security assurances that provided the stability which kept a lot of the region nuclear-free, and (b) providing a lot of the diplomatic heft, initiative, and energy (which I am feeling kind of nostalgic for at the moment) that helped keep the countries from going too far down the nuclear path.

China changed from a proliferator to a non-proliferator over this period. We tried for a long time, unsuccessfully, of course, to stop China from going nuclear. We did not really have much leverage or ability to do that. Once China crossed that Rubicon, the role it played tended generally not to be very helpful for a number of years. They viewed nuclear weapons acquisition as a way to combat hegemony by the great powers. It took until China became much more of a status quo power in its own right for that attitude to change. I think that change would date to the time when Zhao Ziyang met with President Reagan here in the White House. But I think China's critical role throughout that period, and most importantly in the 1993–94 crisis, was to let North Korea know that North Korea could not rely on China to protect it against, for example, U.N. Security Council sanctions, should the global community

decide to constrain and act coercively to stop the North Korean nuclear program. Although they were quiet about it, and although the Chinese never stepped up to the plate in terms of providing assistance, I do believe they played a very critical role at that time.

Russia's role also modified from that of being a general sponsor and a nuclear sponsor—perhaps not as vigilant as it could have been and driven by a variety of commercial and political motives—to a position in which they grumpily, sullenly at times, acquiesced in U.S. efforts to stop the North Korean plutonium production program. The United States first requested that North Korea be required to sign the Non-Proliferation Treaty as a condition of Russia supplying their nuclear power stations. Subsequently—and I think this still does not sit well in Moscow—Russia actually agreed to stop cooperating in building those large nuclear reactors when it became clear that North Korea was in fact engaged in a rampant plutonium production program.

That was the historical challenge. I would like to spend the balance of my remarks talking about the current challenge and what the implications of a nuclearized Northeast Asia might be. We are now in a bad place, and I am afraid it is getting worse. We have had a situation, which you are all familiar with, in which North Korea has broken free from the constraints of the Agreed Framework, under which they had frozen their plutonium program under IAEA monitoring. The North Koreans were caught cheating in their secret pursuit of a capability to make enriched uranium. They were called on it. And the net result is that they walked out of the agreement. They walked out of the Non-Proliferation Treaty, they kicked out the international inspectors, they turned off the cameras, and they broke the seals on the facilities. They seem to have taken the spent fuel rods that contain the plutonium. They claim to have separated the plutonium, and they are certainly broadly hinting at and showing evidence to visiting scientists of what they claim to be their so-called deterrent in the form of separated plutonium.

I think our goal in response here is unexceptionable. There are different ways to explain this mantra, but we are seeking the complete, verifiable, and irreversible disarmament of North Korea. The problem is that we are trying to do

this currently with an approach that was aptly described by Graham Allison as “a policy of no carrots and no sticks.” However desperate the North Koreans may be, they are not so desperate as to take that kind of a deal when they can basically right now continue separating plutonium. Nobody is stopping them, really. Every day they get a little bit better militarily. Every day they get a little more bargaining leverage. We are negotiating with ourselves a lot, and talking to others among the six parties, and we are not really getting anywhere closer to a solution.

In terms of the subject of this conference, and in terms of the role of Russia and Northeast Asia, I think there really is something missing here that need not be missing. This is in fact the place where Russia can play a critical and a useful role. The Russians were disgruntled, as I mentioned earlier, when they felt that they had been squeezed out of a nuclear reactor deal in North Korea in the early 1990s. And they felt that again when the Agreed Framework came through and provided that *other* countries would be supplying nuclear reactors.

President Clinton actually felt strongly that a way should be found to bring the Russians back into the picture, and that it would be a good thing to do. Today I think that there is that kind of an option precisely because of the ability of Russia to provide part of the carrot—that, if we wanted to get a solution on the North Korean nuclear problem, it could come in the form of natural gas. Sig Harrison has talked about a pipeline. It could come in the form of electricity pumped out of Far Eastern generating plants in Russia. If, against all odds, there is some kind of Lazarus-like resurrection of the light-water reactor deal, it could come in the form of taking the spent fuel back so that there is not a risk of plutonium coming out of a nuclear reactor that would ever get built in North Korea.

Again, we should not think about this problem, and Russia’s role, in a very narrow compartment. If we deal with Russia with respect to the nuclear threat, then Russia may have to consider not only Asia, but also the other side of Asia—for example, in Iran. I think that there is the predicate for a possible significant U.S. deal with Russia in which the U.S. and Russia would agree to compromise on their differences on nuclear issues, sign a so-called “agreement for peaceful nuclear cooperation,” allow Russia to

take back spent fuel from other countries—something that Russia itself has passed a law through its Duma to permit—and provide Russia with an opportunity, to use Russian numbers, to earn from \$10 billion to \$20 billion worth of revenue. At the same time, Russia could become a sponge for plutonium-laden spent fuel—not only from North Korea and Iran, but also from South Korea, Taiwan, and maybe even Japan, if the Rokkasho plant ever successfully opens. So I think there is a very important role that Russia could play here, and I believe it is one that requires urgent exploration.

Now, if that does not happen, and if our current efforts to achieve this result of a completely disarmed and a verifiable and irreversible status in North Korea should not succeed, where are we? I don’t know.

But I *do* have some questions. When I go to Asia, I talk to colleagues and friends about this, and I get many different answers. A world with North Korean nuclear weapons would be different in so many ways. But let us just consider it. If North Korea goes overtly nuclear in a way this is undeniable—for example, if they test a nuclear device—what would the world do? Let’s start with the region.

If there were a nuclear threat emanating directly from North Korea, I think the Japanese would feel they would be first in the queue as a target set. And I do not know what the political effect would be. There are, from time to time, statements, perhaps most recently by Mr. Fukuda when he was Cabinet Secretary, suggesting that Japan might go nuclear. I think here you have to come back to the question of how Japan might feel at that time about the strength and reliability of the U.S. nuclear deterrent. But I think that there could be a quite robust debate. Who knows what could happen in the context of an emerging two-party system, if you have an interesting, or perhaps politically volatile, discussion? That is one question.

How would South Korea react? I think that may in turn be partially a function of how Japan reacts. I do not really want to advocate any kind of domino theory, but I think you can pretty easily go around the region and see, when you think of interlocking relationships, as some of the comments from our earlier panelists today suggest, that there are a lot of regional security dynamics that I think could play a role, in a pos-

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itive or negative way, in the outcome of this kind of discussion.

China obviously has a huge security implication around the region. How would they react? Could you possibly consider that without thinking about the Taiwanese, and whether they might resuscitate their nuclear weapons program? Next is India, which has always justified their program for nuclear weapons by China, and then there is Pakistan. That is thinking in terms of worst-case scenarios.

How would the world look? I am not sure, but I am not crazy about that future. There are academic arguments that say, “You could have ‘unit deterrence,’” where everybody is deterring everybody and it is very safe. Some say that the Kargill conflict shows that you can go to war in South Asia, now that both India and Pakistan are nuclearized, and nothing bad will really happen. I am a little too conservative to embrace that as a possibility. I have not even mentioned what I think is actually the scariest outcome, with which I will conclude.

That outcome is North Korea not as a possessor and wielder of nuclear weapons, but as an exporter. There are people who say, “I know they export the Taepo Dong missiles, but nukes are different.” I am not sure I want to rely on North Korean self-restraint. I am not sure about how many things they have scrupled not to sell in the past that were not nailed down. Also think of their favorite trading partners, for example, Pakistan, and the shortest route to al Qaeda, which happens to be through Pakistan. I worry a lot about that. All this brings me back to the current situation. I guess we are going to have another round of six-party talks in September. I do not know that anybody has great ambitions for that round to get us much closer to a solution—and by the way, the North Koreans are still cranking out the plutonium. For me, the prospects of this kind of a future are sufficiently unattractive that I think we should mobilize now to stop them.

That brings me back, in conclusion of my conclusion, to Russia. The United States *should* work with the other countries that are involved in the six-party talks. I do not think we all have to be in the same room at the same time. There are actually very interesting and important things the U.S. could discuss with Russia to bring Russia much more effectively into playing a

constructive role in resolving the North Korean nuclear crisis in a way that could have significant ramifications throughout Northeast Asia, and I would advocate that. I would rather encounter the risks of that kind of aggressive diplomatic approach, and running certain risks now, even in terms of indicating to the North Koreans that their current path has greater penalties than we have so far suggested to them. The alternative is to run the much greater long-term risks of allowing that program to proceed unfettered, which would likely have quite significant and adverse security consequences throughout Northeast Asia. I think that would likely also entail significant potential for political instability and economic distress. Many of the hopes for the future that are now nourished throughout the region could be put in jeopardy if we fail to take an aggressive posture now to stop that program. Thank you.

Discussion

ROBERT HATHAWAY Thank you, Dan. Thanks to all three of our speakers in this panel, because I think we have begun to place the discussions of the last day and a half into a somewhat broader context by this last set of comments. I would invite those of you in the audience to now make comments as well as raise further questions.

Q. I was wondering if some of the speakers could talk a little bit about the Korean population in Northeast China, and what Russia might be thinking of those Korean communities, whether any of the Chinese that are going into Russia are of Korean ethnic origin, and how that factor might be tying into some of the machinations between Russia and China, and perhaps also between Russian and China and either Korea?

GILBERT ROZMAN This is something I investigated specifically when I was in Changchun and Vladivostok meeting with people in the Korean community and scholars who are studying this. I do not think there are big security implications. You are right to suggest that many of the Chinese, maybe the majority, who go into the Russian Far East as traders are actually ethnic Koreans, that those networks are significant, and that there are important exchanges of people across those borders. For

instance, one thing I learned in Jilin Province is that a lot of Korean-Chinese are working in South Korea, many overstaying their visas. But it is much easier for them to get permission to go there and work. They are considered the most desirable foreign labor. They speak Korean, although there are a lot of problems. A lot of North Korean women fill in for these women, who are most likely to go to South Korea, in the rural communities of Jilin in Northeast China. But there is no security issue here that I can think of.

ELIZABETH WISHNICK I would just add that one of my colleagues has been studying the presence of Koreans in the Russian Far East. He did a survey asking Russians if they could distinguish between Chinese, Han Chinese, and Korean-Chinese. Most of the respondents could not distinguish between them. So the issue for the residents in the Russian Far East was not the ethnic origin of the migrants, but their national origin, the fact that they were coming from China. I think that there is a security issue that arises when you have North Korean refugees sometimes crossing into Russia, which creates problems for Russia in terms of what to do about them—whether to repatriate them to China, which has been the typical course, despite human rights objections. I think the Korean issue comes up in that respect.

Q. *I had a quick comment on Gil's presentation, and then a quick question for Mr. Poneman. Gil, I think you nailed down the question of how the pipeline issue started, connected with that summit back last year with the Russians. I would say, though, that I do not think that the Japanese drove it. I think the Russians also, as the hosts of the summit, saw that it was going to be a train wreck. In all the things I was writing at the time, I kept predicting a train wreck because it seemed that the Japanese were going to come in looking for a solution to the territorial question and that there would be no deliverable coming out of the summit. I think that the Russians wisely saw that they could take advantage of a problem that had arisen in their negotiations with the Chinese over delivery prices, and that had stalled an agreement on the Daqing pipeline for a while. The Russians found that they would be in the catbird seat for quite a while if they raised the prospect that the Japanese could get it on the Nakhodka line. In the fullness of time, what happened was that the*

Japanese managed to put up a better economic package than the Chinese had presented. The Russians acted in their own economic interest. And this is something that they have said repeatedly: "look, folks, this is not a geopolitical statement that we are making. This is purely economic, and we will go where we can make the best profit." I would take them somewhat at face value on that, understanding, of course, that there are other geopolitical concerns.

Mr. Poneman, I just wanted to ask you, you did not mention the Highly Enriched Uranium (HEU) program. Does that complicate your analysis, or does it just make it even blacker than it already is?

DANIEL PONEMAN I did mention it, or I meant to, in terms of the precipitating factor for the collapse of the Agreed Framework, which was the discovery of this clandestine enrichment program. It makes the problem much harder. For example, with the release of the Senate Intelligence Report, one of the major takeaways for me is how cautious we need to be about very confident, but still quite uncertain, assessments. What we know about the highly enriched uranium program is far less than what we do not know. We do not know where it is. We do not know how many cascades there are. We do not know what the feedstock situation is. What we do know is that there are five or six bombs worth of plutonium that we have lost. And my concern is that we run a huge security risk if we hold hostage what we *do* about plutonium to what we *think* about uranium.

What I have been trying to think through is how do you square that circle? Obviously, you cannot ignore the HEU. If its there, you have to get it. That is why I do not take any exception to the objective of the administration. But I would not dismiss out of hand a partial deal that recovered the plutonium and got it back under IAEA safeguards and, hopefully, out of North Korea while we are still ferreting out what is happening on the HEU side.

I would entertain, frankly, breaking out some of the carrots and sticks that we are not using on anything and using some of them to get the plutonium program back under control. Then I would withhold some carrots to maintain enough leverage to get whatever else is out there, which would have to entail some kind of intrusive "anywhere-anytime" kind of inspection procedure. I do not know if that would work. But,

How do you balance your need for labor with your need to protect your culture?

again, I think if you ever were to contemplate a more coercive kind of approach, I think we really have to give a much bigger college try at a negotiated outcome. We should at least think about that. By the way, I think that would have the additional virtue of potentially being the most negotiable for the North Koreans. What we are now asking the North Koreans to do up front is: “first of all, admit you lied on the HEU, and then we can talk.” This is not the first thing North Koreans tend to like to do, at least in my experience with them. I came up with this dilemma, waking up in a cold sweat: what if they brought the plutonium to the table, and said, “Here it is?” If you are responsible for the protection of your people, and each one of those five or six things could take out a major U.S. city, are you going to say, “No. I am not interested in that plutonium. Let me see those uranium cascades first.”

I do not think even the most aggressive assessment envisions that the HEU is going to be here imminently. That is why I think we should pursue HEU vigorously, but I think we have got to keep our eye on the ball and get the plutonium.

Q. *I have two questions for Dan. I think your idea about “do not seek everything all at once because the probability is somewhere between slim and none” has a great deal of value. My questions are two-fold. Number one, if in fact a credible North Korean were to come to you and say that they really do not want this nuclear program, what they really want to do is cut a deal, would you believe him/her?*

And number two; you talk about working out some sort of a short-term deal on the plutonium side of the issue, and then figuring out a way to do it. Given that until you have a relationship of some sort, it is hard to understand how they would buy into these sorts of “anytime-anywhere” inspections, what do you think the downside is for the United States of offering some minimal carrot in the process in order to get at least the beginning of some sort of a relationship back on track? Do you see a downside?

DANIEL PONEMAN I will take those in reverse order. I do see a downside. To me, there are a couple of downsides. One is, it is very easy for me sitting up here to say: “Well, just give them a little carrot for the plutonium and save the big stuff for the HEU.” North Koreans might not view it that way. So the first risk is that it would be hard to keep enough back for a larger

deal if you are really focused in a laser-like way on plutonium. The second risk, for which I am less worried about the U.S., but more worried about the other of the six parties, is that once we get the plutonium people will at least feel, if not declare, that the crisis is over, and then we may not have the collective fortitude to bear down and do what it takes to get at whatever it is out there. So, I do think there are downsides.

On your first question, if they came up and said: “We really do not want nukes. We will give it up in exchange for a deal.” No, I would not take them at their word. However, I would test the proposition by providing a deal that was structured in a way—and, in my view, the Agreed Framework was structured in this way—that they do not get the full benefit of the package until they deliver full performance in a verified way on their side. So, I would not take them at their word, on the one hand. On the other hand, if I could get it in some kind of verified way, I would.

Q. *One of the bigger demographic problems in the region, that I am aware of, is the Japanese aging population and resulting lack of people to do the work in Japan in the future. Is the panel aware of any realization in Japan that this is a big problem, or a willingness to do anything about it in terms of immigration policy? And how would various other countries in the region respond to a situation where Japan is willing to take in large numbers of workers in medicine, construction, and a whole variety of areas?*

ELIZABETH WISHNICK I think that it is a big problem in Japan because of the resistance to bringing in large numbers of migrants. For example, there are large numbers of Chinese and Russians working in Japan, and there has been a lot of concern that they are trying to stay longer in Japan to work in activities that are contrary to their visa status. I think it is a problem of cultural identity for countries that tend to be more homogeneous, like Japan. South Korea has the same issues; and Russia to some extent, also. How do you balance your need for labor with your need to protect your culture? The other side of this is that if you enact very stringent rules preventing legalized labor cooperation, you have a problem of illegal labor. All three countries have this problem. It is in fact counterproductive when you try to limit labor too strictly. You per-

haps get the labor that you do not desire, instead of promoting legally the ones that you actually want. But I do not know of any programs that would help to alleviate this situation.

GILBERT ROZMAN I could say a lot about the potential, but I think the simple answer here is that, at this point, Japan has not prepared a strategy for dealing with the age distribution that is about to hit it.

Q. I have a question for both Professor Rozman and for Daniel Poneman. One question refers to what Professor Rozman mentioned as the U.S. role in Russian-Japanese relations. I think this is really important, because the United States could take a positive role in trying to resolve the impasse where both countries find themselves in at the moment by, for example, taking a neutral role on the territorial issue, or trying to come up with some creative ideas to broker a deal between the two countries, such as decreasing visa barriers or promoting some kind of low-level cooperation. I think this is really a good way that the United States could come in and step in at a time when both sides are completely stuck without any creative ideas.

I have another comment to Daniel Poneman. With regard to North Korea, I would like to challenge you on this idea that it would be completely terrible if North Korea went nuclear. We all tend to think that Kim Jong Il is a maniac of some sort. But, you know, some people think that Stalin was a maniac. Stalin had the bomb. Many people think that Mao Zedong was a maniac. Mao Zedong had the bomb. In fact, China tested nuclear weapons at the time of the Cultural Revolution and in 1964 as well. In many cases, the North Koreans were in fact less war mongering than the Chinese in the past, say, 50 years.

What I think the North Koreans are doing is that they are trying to play each power against each other, the way they have done in the last 50 years. They are trying to play six powers against each other. But what I think is important here is not the concern of six powers about North Korea, but the lack of concern of the six powers about North Korea. Once everybody stops paying attention to North Korea, it will have to work out something else. Right now, they are just playing us off against each other.

GILBERT ROZMAN On the U.S. role in the Japan-Russian relations, I think at times over the last 13–14 years that the United States has given encouragement to both sides to try to

resolve this issue. At times that has been welcome, and at times it has not. A lot depends on what the reaction is and what the expectations are. I think they both have to realize that they have an impasse that cannot be resolved, and that they are not going to resolve it in a way that will be most useful for their long-term relations. Right now, I do not think we have that opportunity. Right now, Japan is focused on getting back those islands. They had a compromise position of their own. They did not need the United States to push it through. And they abandoned it. And right now, I do not think Russia is looking for a compromise position, apart from giving back two islands, which had been offered before. So the timing is not right.

My sense is that the United States may again be interested in doing this because we are looking for what the overall structure of this region is. If the United States starts thinking in a long-term framework, then it is quite likely it will try again to push this. At present, there is a “wise man group” formed between Japan and Russia. They are meeting in preparation for next winter’s summit. On both sides there is a hesitation to bring up compromise suggestions. Neither group really feels that it can go against the suggestions of its own government, even though they are designated as people who are not particularly nationalistic, in most cases. I do not think they are going to be able to do it, even through this new mechanism, unless the governments really want to go forward, and only if the governments say, “Well, we want to go forward, but we need an outside force to get some cover.” Then they would both welcome the United States in a kind of return to the trilateral framework that faded in the mid-1990s. But we are not at that point.

ROBERT HATHAWAY Dan, are we overreacting to the prospect of a nuclear-armed North Korea?

DANIEL PONEMAN I think that was a very good point, and I actually do not disagree with a lot of what you say. I do not think that the North Korean people are crazy, and I never liked the term “rogue.” In many ways, they are very shrewd. We often say they play a deuce-high hand very well. So you are absolutely right. They are not really good at a lot of things, but one of

the things they are really, really good at is finding cleavages among the six parties and working them. You all may remember how slow you run in a three-legged race, where two people each have one leg in a burlap sack. Well, here we have a six-legged race. I think we have hobbled ourselves, and I think they are very shrewd about exploiting that. So, I generally agree with that.

However, I do think that there are still reasons for serious concern. Number one, even if they unambiguously acquire nuclear weapons and do not use them, they are not going to put them to any good purpose. I think that the sway and the swagger—especially since they continue to run a failing economy—that would give to their step would only bring bad news to countries in the region, even if the nuclear weapons are never fired in anger, as it were. That is point one.

Point two—I believe that North Korea is ultimately a failed state in the sense that either the North Korean leaders will keep their current system, which cannot survive because of its own internal inefficiencies and problems, or they will open up to the outside world. My sense is they fear a Ceausescu-like result, and I think that is a well-founded fear. The one thing I do worry about is a failing state with nuclear weapons, because then all bets are off. If they think that either they have to use those nuclear weapons in some very menacing way or their regime is going to go the way of Ceausescu, I think that would be a problem.

The final point I would make—and this is the real wildcard—is that North Korea is a promiscuous exporter of bad stuff. The whole notion of deterrence just does not apply when you do not care about killing your own people, when, like al Qaeda, you do not have a return address, and when you consider it an instruction from God to take out the infidels. For all those reasons, even if it is a low probability event, the consequences are so high that I do not think we are overreacting.

Q. *Reflecting upon the overall theme—integration and isolation—I would like to ask each one of you whether you are optimistic about integration in Northeast Asia, or you are more pessimistic and leaning toward isolation as an outcome. If you are optimistic on integration, I wonder if you think that the U.S. forces in Asia, especially Japan and Okinawa, could be reduced. Especially if you consider integration*

proceeding from the six-party discussion, where North Korea would not be menace in the area, plus the transformation of U.S. military force structure. Would these developments lead to a reduction of the military bases in Asia, Korea, as well as in Japan? Thank you.

GILBERT ROZMAN To turn the subject specifically from the Russian Far East to regional prospects for integration, I am pessimistic on the basis of what has happened over the last 15 years. But I think there is momentum in the economic ties, and the shared security concerns and some of the goals of balancing world power by increasing regional power, suggest that the momentum will continue. When past strategies have failed, they have always gone right back and come up with new efforts to try to make a breakthrough. I think we are probably in for a number of additional years of not learning the lessons of the past, of running up against new impasses, and then starting up over again. I would say, after somewhat more struggle along these lines, we are probably going to get a breakthrough towards regionalism—maybe. It may take 10 years.

ELIZABETH WISHNICK I have a problem with the setup of the question. I do not think you can say either integration or isolation will take place. I think that both processes happen simultaneously, that you have forces promoting integration and you have forces resisting it, and that in different localities the outcomes will be different depending on the balance of forces. It will depend on the area-specific factors, I would say.

DANIEL PONEMAN I would defer to my colleagues and their expertise about integration. I am generally optimistic in the long-term considering the very powerful economic forces unleashed, and the incredible efficiency of the workforces. The trends that I have seen so far make me optimistic; subject to some security disruption, which could come in the form of anxiety triggered by something related to China—either general angst about China's growing power or something specific to Taiwan—or related to North Korea.

Now, in the context of force reductions, it is hard for me to imagine. I still view, and maybe it is just old-fashioned, that the U.S. ground and

naval presence in the region is a very powerful stabilizing factor. I can very readily see, and even accept analytically, arguments on how a transformed military may have significant implications for our force structure, and I am not talking about stuff like the Yongsan base and minor adjustments. But I think if the United States draws down its security presence to a point that the underlying confidence—a confidence that I think has been so helpful for so many years in promoting stability and economic growth and in keeping the region non-nuclear—dropped to the point where our commitment was fundamentally questioned, I think it could have adverse consequences.

GILBERT ROZMAN I wanted to add a Korea connection. I have been staying away from the Korea theme here. I think if there is a breakthrough on North Korea, and the six-party talks lead to an economic plan for North Korea, that could be the catalyst for projects that lead to a much more rapid advance of regionalism. It is still very much uncertain.

Q. I have recently been in North Korea, and I think, as you said right now, the economic factor could be key. Mr. Poneman said China changed its own perspective when they started growing economically and became a superpower—they changed their opinion about nuclear issues. I was very much surprised that even at high levels, like governors of provinces, they indicated a desire to be involved in economic processes. It is a change in mentality. People who get American dollars or other hard currencies are changing very quickly. You spoke about 10 or 15 years in negotiations about nuclear issues. But economic relations could be a process that can change society very much. And I wonder if the United States has any plans to act accordingly? Thank you.

GILBERT ROZMAN Well, it is a good question. I think that the glib, but maybe not entirely inaccurate, answer is “no.”

I will qualify that—I think your question deserves a better answer than that, and I hope to give one. I think the view is, now, North Korea is run by a brutal dictator. We do not want anything to do with him. He is a liar. And therefore, the nuclear issue must be brought to heel first. After that, then we could talk about a lot of things, including economics.

I think there have actually been some missed opportunities. I think the fundamental premise of your question is correct. Indeed, if one had the ability to rewrite history, I think that the agreed framework opened an opportunity to go much further down that road than we did. We were constrained by a lot of factors after the agreed framework was signed. We were constrained by the South Koreans—this was pre-Sunshine Policy. We were constrained by the U.S. Congress, with certain very important exceptions, such as Chairman Hamilton.

Q. My question is for Dan. Since you were involved in the first round of talks that arrived at the agreed framework, and you have observed what's going on currently, what do you perceive it was that finally caused the North Koreans to want to capitulate and/or cooperate in 1994? Where do you see us currently relative to where they were then, in terms of coming to some sort of resolution?

DANIEL PONEMAN I think by June 1994 the Koreans felt they had nowhere left to turn. We had worked so hard to get China, South Korea, Japan, and Russia all on the same page. We even got Suharto, as the head of the Non Aligned Movement (NAM), to write a letter. The North Koreans were trying to turn this into a NAM kind of issue, and they could not do it. We got two U.N. Security Council resolutions putting pressure on North Korea. We even got a U.N. General Assembly resolution on this. They had nowhere left to turn. They had no assets to fall back on. We had been relatively quietly building up our military assets in the Korean theater, but I am sure the North Koreans knew we were strengthening our forces there. Right at that point, in June of 1994, with the confluence of all these factors, a kind of desperation led them to take this kind of frantic, panic-stricken defueling action, which in turn precipitated the U.S. going to the U.N. Security Council.

I would say it was the combination of the following factors: The anxiety in North Korea at the prospect of U.N. Security Council sanctions; the lack of confidence that the Chinese would save them from those sanctions; the awareness of the firmness of the U.N. Security Council commitment, bolstered by the Apaches and everything else that we had been sending to the theater; and then, critically, we gave them an exit,

because we let President Carter go there, and we gave them a face-saving exit.

I must say, looking back, the thing that President Clinton brought into every meeting, always thinking like a politician, was: “We got to give them some way to say ‘yes’.” That is what is missing now. I have no quarrel with the objective. But we have not shown them an escape route, if they want to climb back from the limb.

We have not given them that. We also, and this is an important part of it, have not given them a significant upside for cooperation, and we have not given them a significant downside for defiance. In fact, we drew a bunch of red lines last time; this time, they have not drawn a single red line. The North Koreans are not stupid. They are creeping forward because they have got that running room. That is what is missing, in my view.

Contributer Biographies

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Joseph Ferguson is Director of Northeast Asia Studies at The National Bureau of Asian Research (NBR) in Seattle, WA. From 1999 to 2001 he was a visiting Fulbright Fellow at the Institute of World Economy and International Relations (IMEMO) of the Russian Academy of Sciences. He was also a recipient of a Monbusho Fellowship from the Japanese government to research Japanese-Russian relations in Tokyo. From 1995-99, Mr. Ferguson worked as an analyst with the Strategic Assessment Center of Science Applications International Corporation (SAIC) in McLean, VA. He was educated at Johns Hopkins University Nitze School of Advanced International Studies (SAIS) and Pomona College.

John Fetter has been a consultant and executive specializing in energy and environmental improvement for over 25 years. He is President of FSI Energy, which supports clients with energy services that include purchasing gas and electricity, optimizing processes to minimize energy consumption, and developing cogeneration and combined cycle opportunities. Since co-founding FSI Energy 16 years ago, Mr. Fetter has performed energy related evaluations for corporate clients in the United States, Mexico, Europe and Asia. He is currently leading the development of the KoRus natural gas pipeline from Sakhalin, Russia to the Korean peninsula, along with Korean and Russian partners. This \$3 billion

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Eugene K. Lawson became President of the U.S.-Russia Business Council in January 1993, having been Vice Chairman of the Export-Import Bank of the United States since 1989. While at Ex-Im Bank, Mr. Lawson was the Bush Administration's point man on negotiations to conclude the \$2 billion Oil and Gas Framework Agreement with Russia. From 1988 to 1989, he was Deputy Under Secretary of Labor for International Affairs and, concurrently, U.S. Ambassador to the International Labor Organization in Geneva. From 1984 to 1988, Mr. Lawson was Executive Director of the Washington office of Russell Reynolds Associates, an international executive recruiting firm. From 1981 to 1984, he was Deputy Assistant Secretary of Commerce for East Asia and Deputy Assistant Secretary of Commerce for East-West Trade. From 1977 to 1980, he was Director of the Master of Science in Foreign Service Program and Director of the Program for China Studies at Georgetown University's School of Foreign Service. Mr. Lawson served as Deputy Director of the State Department's Office of Special Bilateral Affairs from 1975 to 1977 and earlier as Staff Assistant to the Assistant Secretary of State for East Asia. From 1973 to 1974, he was a Guest Fellow at the Brookings Institution. He was an officer in the U.S. Navy in the Pacific from 1961 to 1963. Mr. Lawson graduated *cum laude* from Princeton University, holds a Ph.D. from Columbia University, and is the author of *U.S.-China Trade: Problems and Prospects*, *The Sino-Vietnamese Conflict*, and numerous articles and book reviews. His latest book, *Russian-Eurasian Renaissance? U.S. Trade and Investment in Russia and Eurasia* was co-authored by Jan Kalicki.

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