The Nature of Chinese Influence and Power in Russia's Far East

Testimony of Professor Stephen Blank

Strategic Studies Institute

US Army War College Carlisle Barracks, PA 17013

To the House Committee on Foreign Relations Subcommittee on Europe, Eurasia, and Emerging Threats

China's Rapid Political and Economic Advances in Central Asia and Russia

The views expressed here do not represent those of the US Army, Defense Department, or the US Government

April 16 2013

Russo-Chinese relations possess immense importance for world politics and Asian international relatoins in particular, with the most critical zones of this relationship being Northeast and Central Asia. Since 2008 if not earlier Russia has reoriented tis foreign policies to emphasize the recovery of its previous status in Asia, namely the ststus of a major indepenent Asian player whose government had to be consulted or at lest reckoned with concerning any major alteration or issue in global and Asian international affairs. Moscow, like everyone else, fully understands that East Asia is now the most dynamic sector of the global economy from which it cannot remain aloof if it is to be a major economic and political actor in world affairs. It also understands that Northeast, Southeast, South and Central Asia, i.e all of China's peripheries, are also potentially very dangerous areas in world politics and that in many cases, as we now see in Korea, a breakdown in security threatens its vital interests. Moreover, it is very clear from its defense and foreign policies that Russia seeks to hedge against the possibility that China might use its growing power and capability to attempt to become an Asian hegemon. Therefore a precondition for Russia recovering the status of a great, independently acting, Asian power that it covets is the redevelopment of the Russian Far East (RFE)

But for Russia to regain that status it must overcome the legacy of years of misdirected and misconceived Soviet economic and other policies and of continuing systematic misrule. Therefore Russia must reverse the continuing trend towards the depopulation of its Far East and modernize its economy so that it can offer something that Asians either want or need to buy besides energy and weapons. Even in those sectors there are problems. In many cases Russian weapons are not especially competitive and Moscow faces growing pressure in world markets form Asian producers like China and even South Korea. As for energy, the shale gas revolution and continuing discovery of new sources, e.g. methane hydrate and other forms of methane gas, call its future ability to export energy at comeptitive prices and dominate regional or international markets into question. While the RFE is potentially a treasure trove of hydrocarbons, timber, minerals, including so called rare earths, etc. there are severe obstacles to its development and modernization. Some of those obstacles are natural, e.g. a harsh unforgiving climate, topographical obstacles to devvelopment that make the extraction of minerals and hydrocarbons exorbitantly expensive. But most of the other obstacles to development there are man-made, the product tof years of misrule, bad economic decisions, and systematic underinvestment.[1] For example, whereas in the late Soviet period the government invested 31 percent of GDP in the last ten years the figure is 21.3 percent compared to China's 41 percent. Whereas the USSR built 700 KM of railways a year the present government only built 60KM in 2009.[2] Similarly the total length of paved roads in Russia in 2008 was less than in 1997, a sure sign of governance failure and misallocation of resources.[3] As Zbigniew Brzezinski wrote,

> Informed Russian observers are also increasingly concerned that Russia's reliance on capital inflow in return for Russia's oil and gas is breeding a decline in the country's capacity to sustain technological innovation and industrial dynamism on the global competition for economic preeminence. The renewal of Russia's industrial infrastructure, which in Soviet times was being replaced at an annual rate of 8 percent, has declined to 1-2 percent, in contrast to the 12 percent of the developed world. No wonder that the World Bank reported in 2005 that fuels, mining products, and agriculture accounted for 74 percent of Russia's total exports, while manufactures accounted for 80 percent of Russia's total imports.[4]

Consequently Russia has recovered more slowly from the 2008 economic crisis than did the other BRIC countries, Brazil, China, and India.[5] Since foreign direct investment in

Russia is a fraction of the total for the other BRIC members, 4.1 percent for 2007, that pace of recovery will probably not change anytime soon.[6] Not only reportedly about 20 years behind the developed countries in industrial technology, Russia also develops 20 times fewer innovative technologies than does China and devotes considerably less money to research and development than China does.

> Prime Minister Wen Jiabao of China, when visiting Russia in 2007, noted with satisfaction that Chinese-Russian trade in machinery products reached an annual level of $6.33 Billion. Out of politeness, however, he refrained from adding that $6.1 Billion of that sum involved Chinese machinery exports to Russia, leaving only $230 million of Russian machinery exports to China. Making matters worse, projections by the Organization for Economic Cooperation and Development for the year 2020 envisage not only China's gross domestic product as approximately four times larger that Russia's, but with India ahead of Russia as well.[7]

Although some misguided Western analysts believe that Russia has laid the foundations of a market economy, Russia cannot follow China or the West because its system actually represents the antithesis of a market economy. Even if there are markets and growth, there is neither an unconditional right to private property under law, nor any concept of a legally accountable political or state authority. The deep-rooted problems of the RFE can therefore only be overcome by sustained, coherent, and rational economic policies which are still not in evidence. For example, although timber exports frosm the RFE are vital, according to President Putin the Russian government only has data on the quantity and quality of its forest industry for 19% of its forests.[8] Similarly this buisness is, like other sectors in the Far East, plagued by corruption and general lawlessness.

> Russia's forestry business has been in the doldrums for the past two decades, marred by poor governance, low investment potential and the growth of illegal felling and illegal timber sales. Up to 20 percent of timber logging or about 35 million cubic meters of timber is illegal, with economic damage from illegal timber sales estimated at 13-30 billion rubles ($420-$970 million) annually, according to WWF Russia and World Bank data.[9]

Indeed, many of these pathologies continude to this day. A recent report by the prestigious Valdai Club found that,

> **First**, by degree of involvement in the Asia-Pacific economy Russia is second lowest among APEC countries – only ahead of Papua-New Guinea. The Russian Far East is virtually absent from the economic map of the region. The other Asia-Pacific countries see no need to turn to Moscow for a discussion of various free trade zone projects. It is precisely for this reason (and not due to the petty schemes of enemies) that U.S. Secretary of State Hillary Clinton in her policy article, entitled America's Pacific Century, made no mention of Russia. Regrettably, there is nothing worth mentioning.[10]

Beyond the second problem, of insufficient infrastructure that is already underlined above the third problem is,

> **T**hat scarce labor resources are the key problem of the Transbaikal region and the Russian Far East. There is a general shortage of personnel, not just skilled employees. Two decades of population flight from the region and of the social marginalization of many of those who stayed hit hard the region. Hence the fond dreams of building dozens of new factories in the region are utopian by definition. One has to clearly understand that, for these dreams to be realized, the labor force would have to be imported. There are no domestic labor resources. The architects of ambitious projects prefer to overlook this issue for understandable reasons. Is regional public opinion prepared for the new industrialization of the Transbaikal region and the Russian Far East to be accomplished by Chinese, Korean, Vietnamese, and Indian workers? At this point, it is unlikely.[11]

Given this problems it is, therefore, hardly surprising that in fact, Russian authorities have, for quite some time, actively welcomed Chinese migration to the RFE. If we remember that energy is by no means the only important economic issue in the RFE and that its labor shortage is an equally acute problem hampering its development; we quickly come to realize that the real Chinese penetration of the RFE has little or nothing to do with fantasies of vast hordes of Chinese migrants taking over the land. In fact, as a recent Chinese article observed, the RFE cannot afdfrod to spurn Chinese labor and/or capital.[12] Russian scholars make the same agument. Indeed, they note that Moscow has largely abandoned the effort to stimulate Rusisan migration from other parts of Russia to the RFE having recongized the infeasiblity of such programs.[13] Thus while this Chinese argument is obviously self-serving; it also reflects the truth and the actual migration figures testify to the continuing failure of Russia's supposedly welcoming policy towards such labor and other migration. Part of the problem is the continuing diffusion in and out of Russia of scare stories about hordes of migrants seizing Russian land. Such images of the "Yellow Peril" dating back to Kaiser Wilhelm II who first originated the term in 1895 are vastly overdrawn and have little conneciton to reality though they provide good political fodder for Russian extremists and uninformed foreign observers. In fact there are probably about 250-300,000 Chjnese settlers throughout the area and many of them are shuttle traders. Moreover, there are no signs that Chinese people seek to settle in the RFE and indeed the number of Chinese citizens enteirng Russia has decreased since 2000.[14]

Rather the real penetration is the steady Chinese encroachment upon and acqusition of economic and political leverage in Russia's industries and raw material sectors, including energy. This trend, more than anything else, is the real threat to Russian national interests and the attainment of its goals in Asia.[15] Because Russia, despite its growth since 1999, still lacks the capital and technological knowhow to overcome the natural and man-made obstacles mentioned above, it must form partnerships or business alliances (not security alliances) with other interested actors to develop the key sectors of the RFE: exploration of oil and gas fields, builidng refineries and pipelines for those hydrocarbons, exploration and development of a production and transport infrastructure for liquefied natural gas (LNG) and commerical trade in general, i.e. roads, power generation, timber and timber processing, telecommunications, repair of environemtnal degradation. etc. And because this region is also tied to those parts of the Arctic region that are situated in Asia and the Northeastern segments of the so called Northern Sea Route through the Arctic Ocean some aspects of the related issues generated by the opening up of the Arctic to more commercial exploitation include the RFE and Eastern Siberia.

The manmade obstacles include such structural features of the economy as dilapidated transport infrastructure and power transmission, high labor costs, and low productivity, shrinking population base as people migrate from the RFE to European Russia, and the usual features of state administration in Russia. These typical and regressive, even pre-modern facets of governance include widespread corruption, criminality both within and outside of local, regional, and the central government, excessive centralization from Moscow and the ensuing ignorance of local conditions, the manipulation of tax rates, capricious environmental, and business laws to make it difficult if not unrewarding for foreign buisnesses to invest here, and uncontrolled bureaucratic factionalism. That latter factor also corrupts foreign policy.

As a result the only areas where Russia seriously competes economically in Asia relate to the exploration and exports of energy deposits on land and/or sea, and arms sales to Asian countries like China, India, and Vietnam. Furthermore its quest for energy and other investment partnerships has not been very successful. India's Oil and Natural Gas Company (ONGC) is invested, as are some Japanese firms, in gas deposits on Sakhalin and ONGC is also considering further investments in the RFE and Arctic. Although there are signs of a thaw with Japan, no large-scale Japanese investments in the energy field beyond Sakhalin have not yet materialized and one should not expect any rapid developments here. This is not just due to the long-standing impasse concerning the future status of the Kurile Islands annexed by the Soviet Union afer 1945. Japanese business, though it clearly wants to invest in Russia, is at the same time very leery of investing in a market famous for being a high-cost production plaform with low levels of labor productivity, but high rates of extortion, expropriation, corruption, criminality, kickbacks, etc.

On the Korean peninsula Russia's dream of a raiload connecting the Trans-Siberian Railroad with a trans-Korean railroad (TSR-TKR) has remained a dream but not a reality since the 1890s. Likewise, the dream of builidng a trans-Korean pipeine for gas that would bring Russian gas to South Korea thorugh the North, thereby enhancing Russia's status, helping satisfy South Korea's demand for gas, and giving North Korea access to gas and lucrative tariffs has gone nowhere. And given the current crisis generated by the DPRK no progress should be expected here. While Russia is courting Southeast Asian investors, it is obvious that they cannot furnish the capital and technologies that Russia needs except in limited cases and to a limited degree.

Thus by default this leaves China as the only major foreign investor with whom Russia has hitherto been able to make major deals in the RFE. And China, as we know is hardly reticient about pressing its advantage and demanding special terms and treatment. Russia has had to resume seling China advanced miliary technologies, not least to sustain Far Eastern defense industries as Middle Eastern markets have dried up since 2011. And this is despite the fact that Russian arms sellers have ben irate for years about China's pirating of Russian technologies, intellectual property, and knowhow. Here strategic considerations and sectoral rather than rational economic thinking trumped political interests in not selling wepaons to potential enemies. What makes this even more irraitonal is the fact that there is no doubt that the Rusisan government and General Staff fully gtrasp the nature and trends of Chinese military capabilities and potential for threatening Russia. In the oveall economic sphere of Russo-Chinese relations we see, in fact, many tensions that belie the notion that relations are better than ever and that a total identity of interests exists between them.

To be sure there is much convergence against US policies but in fact Russo-Chinese trade relations are the achilles heel of the reationship. Russia constantly complains that China does not buy Russian goods except for raw materials. Bilateral trade balances favor China and China is able to drive a hard bargain on energy. For all the talk of perfect harmony, despite twenty years of talks there is still no gas pipeline to China. The main reason for this is that China has been able to refuse to pay more than the price it pays for coal for the gas while Russia demands world market prices. Moreover, China probably also wants to be the only customer for this gas, a situaiton that means it actuay owns the pipeline. It probably does not want to allow for a pipeline to continue on to other Asian states like South Korea. By making major deals with Central Asia and Australia and now exploring for shale gas, which Gazprom amazingly calls a bubble, China not only gets more gas from Central Asia than does Russia, it is able to exploit other osurces and essentially tell Russia that if it does not accept Chinese demands on price China has other altenrnatives.

An article by the former Indian diplomat M.K. Bharakumar demonstrates how China has been able to force Russia and Gazprom -- which it is in a position to bail out due to its corruption and state-mandated improvidence – to reverse their desires and accept not only China’s price demand but also China’s long-standing demand for enhanced leverage in Russia’s gas sector.

> Russia has been insisting on a price on par with what it was getting from its European customers - roughly US$400 per thousand cubic meters [Mcm], whereas China insisted on $250 per Mcm. Second, Russia was offering gas supplies from its East Siberian gas fields via the so-called Altai route, whereas China's preference was for supplies from a much shorter eastern route that could keep down the cost of transportation. Moscow has now accepted the eastern route, which is a pragmatic decision, because Russia's hope was to emerge as a swing supplier between Europe and Asia. On the other hand, the eastern route means that the cost of the gas falls significantly and comes much closer to the Chinese offer of $250 per Mcm. Now indications are that for reducing the remaining price gap of some $50 per Mcm, China might be willing to make an upfront payment of $25-30 billion to the Russian gas company Gazprom that can be set off against the gas exports over time. Gazprom needs to borrow at least $25 billion from financial institutions to fund this very project that would supply gas to China. Had it borrowed from the money market, it would have had to pay interest, while if China decides to give the money interest-free, the loan would bridge the remaining price gap. Indeed, this mega deal will be a game changer in the Russian-Chinese partnership.[16]

As regards oil, it is Chinese money in the form of huge loans of $15 Billion to Rosneft and $10 Billion to Transneft that got the East Siberian Pacifc Ocean (ESPO) pipeline built after 2009. Yet the first year that ESPO was in operation it was basically tied up in litigation. Although those issues seems to have been resolved, ESPO’s underperformance has created a dangerous situation due to the rivalry between Rosneft, headed Igor Sechin one of Putin’s closest henchmen, and Gazprom. Sechin has clearly bet on obtaining huge Chinese loans in return for contracts to sell it oil and/or gas to make Rosneft the number one firm in Russia. At the recent Sino-Russian summit he gained a contract to triple the size of current oil deliveries to China to 900,000 BPD, putting it on a par with Saudi deliveries to China.[17] But he won those contracts only at the price of agreeing to further huge loans of $25-30 Billion from China as infusions of cash to Rosneft and agreeing to facilitate Sinopec’s acquisition of oil and gas assets in

Russia Specifically Rosneft would consider Sinopec's participatoin in its large-scale project in the RFE,the Eastern Petrochemical Reifnery jointly esta blished in 2007 by Rosneft and Sinopec's rival CNPC, China Naitonal Petrochemical Corporation.[18] While China may become Russia's biggest customer, it will do so while it has an enormous cushion of alternative supliers and very likely leverage over oil and gas pipelines that go exlcusively to China. Meanwhile Moscow will depend excessivley on exports to China in Asia thorugh these leveraged pipelines. This, as energy experts know, is not a winning strategy for Russia. But this sequence illustrates how the pursuit of sectoral, peronsal, and factional gain and short-term horizons of getting cash to cover debts run up due to irraitonal market decisoins and state policies is undermining Russia's position not only in Asia but even at home in the RFE.. Thus these deals may well come at the expense of Russia's national interest and come with stirngs attached as China is gaining leverage on key elements of Russia's crown jewel, its energy sector. Similarly, even though China is ramping up its Arctic presence and disputes Russia's claim to much of the Northern Sea Route and the Arctic's waters as part of its Economic Exclusion Zone, Russia recently signed several agreements with China to provide capital for its exploration of the Arctic.[19]

If we remember that energy is hardly the only ecponomic issue lof consequence in the RFE we come to relaize that the real Chinese penetration of the RFE has little or nothing to do with fantasies of vast hordes of Chinese migrants   taking over the land. Such images of the "Yellow Peril" dating back to Kaiser Wilhelm II who first originated the term in 1895 are vastly overdrawn and have little conneciton to reality though they provide good political fodder for Rusian extremists and uninformed foreign observers. In fact there are probably about 250-300,000 Chinese settlers throughout the area and many of them are shuttle traders. Rather the real penetration is China's steady encroachment upon and acqusition of economic and political leverage in Russia's industries and raw material sectors, including energy. This trend, more than anything else is the real threat to Russian national interests and the attainment of its goals in Asia.[20]

This trend, if allowed to continue without interfernce or substantial rivalry could, over time, undermine Russia's efforts to bandwagon with China against US policy on the global scale, missile defense, democracy promotion, and proliferation, while hedging with other Asian states against China's claims to regional hegemony. We see this dual trend in Southeast Asia where Russo-Chinese relations are deicidedly different from the alleged sweetness and light that both capitals would have us believe is the real story. In the contested South China Sea we find an almost opposite situation. Here Beijing has also repeatedly told Moscow to terminate its energy explorations there, clearly in response to Russia's display of its enhanced interests in boosting its presence in Southeast Asia. In 2012 Russia announced its interest in returning to a naval base at Cam Ranh Bay, a step probably connected to joint Russo-Vietnamese energy projects off Vietnam's coast, and as a means of checking China. Gazprom announced on April 6, 2012 that it had signed a deal to take a minority stake in the development of two gas projects off the coast of Vietnam. Gazprom will explore two licensed blocks in the Vietnamese continental shelf in the South China Sea. It took a 49% stake in the offshore blocks, which hold an estimated 1.9 trillion cubic feet of natural gas and more than 25 million tons of gas condensate. Those actions precipitated Beijing's demand to Moscow that it leave the area. However, while Moscow was silent, no doubt, to avoid antagonizing China, Moscow never left the South China Sea. And since then it has doubled down in support of Vietnam, both with regards to energy exploration in the South China Sea, and perhaps more ominously from China's standpoint in arms sales and defense cooperation.[21]

The upshot of all this is that while Russia and China profess n identity of interest vis-a-vis the US; that identity exists only insofar as global issues are concerned, inervention on behalf of democracy as in Syria, missile defenses, democracy promotion and proliferation as a potential spur to armed intervention. But while both governments resist US regional policies against Notrh Korea and Iran and in Central Asia, Russia clearly wants to hedge against China's domnance in East and Central Åsia. Thus there is a subterranean rivalry, even on the acquisition of influence over North Korea between them. But just as we see a growing rivalry between China and Russia in Central Asia due to China's ever more visible commercial and financial superiority there which Russia cannot match, we see the same kind of phenomenon in East Asia. Here too Russia evidently cannot compete with Chiense economic and financial power and it is ever more apparent that China is the only foreign investor of any consequence in RFE and Siberian projects of great and growing importance to Russia. China is steadily accumulating pressure points or points of leverage inside Russia's economy because of the pervasive misrule Russia has displayed here. In that context, then, it would be unusual if China were to refrain from seeking, as it has elsewhere, to convert economic leverage into lasting political advantage.

[1] Fiona Hill and Clifford Gaddy, *The Siberian Curse: How Communist Planners Left Russia out in the Cold* (Washington, D.C.: Brookings Institution Press, 2002).
[2] "The State of Russia: Frost at the Core," www.theEconomist.com, December 11-17, 2010
[3] Anders Aslund, Sergei Guriev, Andrew C. Kuchins, "Russia's Course: Viable in the Short Term but unsustainable in the Long Term," Anders Aslund, Sergei Guriev, and Andrew C. Kuchins, Eds., *Russia After the Global Economic Crisis,* Washington, D.C.: Peterson Institute for International Economics, Center for Strategic and International Studies, New Economic School, 2010, p. 259
[4] Zbigniew Brzezinski, "Putin's Choice," *The Washington Quarterly*, XXXI, No. 2, Spring, 2008, p. 109
[5] Moscow, *Interfax*, in English, November 23, 2010, *FBIS SOV*, November 23, 2010
[6] Susanne Oxenstierna, *Russia in Perspective; Scenarios of Russia's Economic Future 10 to 20 Years Ahead*, Stockholm: Swedish Defense Research Agency, 2010, p. 24
[7] Brzezinski, p. 109
[8] "Vladimir Putin Criticizes Officials for Situation in Forestry Sector," *ITAR-TASS News Agency*, April 12, 2013, http://www.itar-tass.com/en/c142/704882.html
[9] "Putin Earmarks Financing Russia's Forest Industry," *BSR Russia*, April 11, 2013, http://www.bsr-russia.com/en/agribusiness/item/3607-putin-earmarks-financing-russias-forest-industry.html
[10] Timofei Bordachev and Oleg Barabanov, "Siberia and the Far East as a Path to Russian Globalization," www.valdaiclub.com/economy/53980.html, January 23, 2013
[11] *Ibid.*
[12] "Russia's Far East Region Can't Afford to Spurn Chinese Labor and Capital," *Global Times*, March 14, 2013, http://www.globaltimes.cn/content/768157.shtml
[13] Zhanna Zayonchkovskaya, "Immigratsiya: al'ternativy net" [Immigration: there is no alternative], in V. Mukomel', E. Pain (eds.), "Nuzhny li immigranty rossiyskomu obschestvu" [Does the Russian Society Need Immigrants?] (Moscow: Fond Liberla'naya Missiya, 2006), 30; Victor Larin, "*Strategy for Economic and Social Development of the Far East and Baikal Region for the Period until the Year 2025* (December 2009), available at: http://www.government.gov.ru.
[14] Victor Larin, "KNR glazami dal'nevostochnika" (The PRC as viewed by a Russian Far East resident), *Mezhdunarodnie protsessy (International Trends),* (2010), 1:125, 128.
[15] Stephen Blank, "Toward a New Chinese Order in Asia: Russia's Failure," *NBR Special Report* No. 26, National Bureau of Asian Research, March, 2011
[16] M.K. Bhadrakunar, "Xi, Putin Share Bed, With their Own Dreams," *Asia Times Online*, April 12, 2013. www.atimes.com
[17] *Ibid.*
[18] Dmitry Zhdannikov and Vladimir Soldatkin, "Exclusive: Russia Plans $25-30 Billion-Oil-For-Loans Deal With China," *Reuters,* February 13, 2013; "China May Grant Rosneft Loan for More Oil – Dvorkovich," *RIA Novosti*, February 27, 2013, http://en.rian.ru/business/20130227/179711229/China-May-Grant-Rosneft-Loan-for-More-Oil---Dvorkovich.html; Taipei, *World China Times*, in English, April 14, 2013, *FBIS SOV*, April 14, 2013

[19] Atle Staalsen, “China to Drill in Barents Sea,” *Barents Observer*, March 25, 2013, http://barentsobserver.com/en/energy/2013/03/china-drill-barents-sea-25-03

[20] Stephen Blank, “Toward a New Chinese Order in Asia: Russia's Failure,” *NBR Special Report* No. 26, National Bureau of Asian Research, March, 2011

[21] Stephen Blank, “Russia’s Ever Friendlier Ties to Vietnam—Are They a Signal to China?” *Eurasia Daily Monitor*, November 30, 2012