

Confidential

RUSSIA

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Yuri Fedorov reports from Prague:

RUSSIA'S EASTWARD PIVOT: PROBLEMS AND OUTLOOK

ANNOTATION

Russia's "Eastward Pivot" strategy, which was announced in the early 2010s, includes the following components:

- *Stronger political and strategic role played by Russia in the Asia Pacific;*
- *Much closer economic ties with the East Asian countries;*
- *Accelerated economic development of the Russian Far East and Eastern Siberia; achieving an improvement in the social standards in these parts of Russia by attracting investors, primarily from the Asia Pacific countries.*

Moscow is currently placing a special emphasis on ramping up its oil and gas exports to the Asia Pacific. Initially this was regarded not as an end in itself but one of the key instruments of achieving the goals outlined above. This issue was covered in great detail in PIR Center expert Yuri Fedorov's recent analysis for Russia Confidential. Fedorov argued that unless an increase in Russian energy exports to the Asia Pacific goes hand in hand with strengthening of Russia's political, strategic, and economic positions in the region, Russia risks turning into a source of hydrocarbons for the leading regional powers, and not much else.

In this issue of Russia Confidential, Fedorov looks at the current state and outlook for Russia's efforts to bolster its presence in the Asia Pacific. He focuses on the general aspects of military-political cooperation between Moscow and the region's capitals; Russian arms exports to the region; and the development of economic ties - especially bilateral trade and Asian investment into the Russian Far East and Eastern Siberia.

Russia's military-political role in East Asia depends on its ability to:

- **Project military power to current and potential conflict zones, especially in the South China Sea;**
- **Act as a political and military counterbalance to China, since many of the region's countries are worried by China's growing military might and the risk of a Chinese military expansion, so they want to strengthen their ability to maneuver between China and the United States.**

Russia's main power-projection instrument in the Asia Pacific is the Russian Navy. The Russian naval capability in the region is not great. Russia's Pacific Fleet is not nearly as strong as the U.S. 3rd and 7th Fleet, or the navies of China and Japan. Nuclear submarines aside, it has roughly the same level of capability as the South Korean Navy.

	Russia	USA	Japan	China	S. Korea
Aircraft carriers	-	5-6	-	1	-
Cruisers	2	12	-	-	-
Destroyers and large anti-submarine ships	8	28	44	31	12
Large landing ships	5	16	3	28	5
Frigates	-	12	6	45	10
Non-nuclear submarines	8	?	18	77	12
Non-strategic nuclear-powered submarines	12	26	-	9	-
Strategic nuclear submarines	4	8	-	5	-

Table 1. Main warships in service with the Russian Pacific Fleet, the U.S. 3rd and 7th Fleets, and the Navies of Japan, China, and South Korea. Based on open-source data.

Russia has no aircraft carriers in the Asia Pacific, too few landing ships, and only a fraction of the number of destroyers operated in the region by the U.S., Chinese, or Japanese navies. Destroyers are in fact regarded as the main oceanic warships in this day and age. As a result, any Russian military intervention in conflicts in the Asia Pacific is highly unlikely.

Russia does not have any naval bases in the region, which severely limits its naval capability. The Russian Navy had a single regional base in Cam Ranh, Vietnam, but left it in 2002. Restoring Russian naval presence in Cam Ranh has been one of Russia's strategic goals since the late 2000s. After very difficult negotiations, in November 2013 Hanoi agreed in principle to host a Russian naval supply station in Cam Ranh. But under the terms of the arrangements agreed during a recent meeting between President Putin and the head of the Communist Party of Vietnam, Nguyễn Phú Trọng, Russian ships still need to notify the Vietnamese port authorities each time they enter the country's territorial waters.

Another reason for Russia's inability to act as a military counterbalance to China is the Chinese superiority in ground forces in the Far Eastern region (see Table 2).

	Russia		China	
	Eastern MD	Beijing MD	Shenyang MD	
Personnel	~80,000	250,000	237,000	
Tanks	865	1,745	1,467	
Armored fighting vehicles	1,583	2,419	1,959	
Artillery	1,424	3,287	3,231	
Army helicopters	171	182	144	

Table 2. Numerical strength and weapons of Russian and Chinese ground forces along the Russian-Chinese border. Based on open-source data.

Russia's ability to maneuver its troops along the Chinese border is also limited due to

poor transport infrastructure. It would also be difficult to bring in troops from central Russia to the Far East. In other words, the Chinese will be in a very advantageous situation if a military conflict breaks out.

On the whole, the Asia Pacific countries' political interest in Russia as a possible geopolitical counterbalance to China is minimal because of the growing economic and military-political ties between Moscow and Beijing.

ARMS EXPORTS

For Russia, arms exports are not only a cash earner but also an important instrument of military-political influence. In recent years the share of Russian arms exports destined for East Asia was 12-15 per cent of the total. It accounted for only 1 per cent of Russian trade with the region's countries, and 2.1-2.2 per cent of Russian exports to the region. Obviously, Moscow is trying to ramp up its arms exports to East Asia - especially exports of naval weaponry, aircraft, and air defense systems.

	1992-2013		Including (bn dollars)	
	Total (bn dollars)	Share of Russian weaponry in country's defense imports (%)	2012	2013
China	31.3	81	0.667	1.04
Vietnam	4.0	90	0.738	0.334
Malaysia	1.8	28	0.002	0.012
Myanmar	1.6	38	0.149	0.143
Indonesia	1.1	21	0.022	0.340
Total	39.8	-	1.578	1.869

Table 3. Russian arms exports to East Asia. Source: Stockholm International Peace Research Institute

China and Vietnam are Russia's two largest defense customers in East Asia. In the 2007-2012 period Russian arms exports to **China** fell by about 50 per cent compared to 2000-2005. China's own defense industry had ramped up its output, enabling the country to reduce imports. As a result, in 2012 Russia agreed to supply to China its most advanced weapons systems and to transfer the underlying technology - something it had hitherto been avoiding. In 2012 Russia and China signed contracts for 140 *AL-31F* aircraft engines (worth 700m dollars) and several *Amur-150* diesel-electric submarines (about 2bn dollars). In 2013 Russia agreed to supply 24 Su-35 fighters. In 2014 an agreement in principle was reached that starting from 2016, Russia would supply six battalions of the *S-400* SAM system, worth about 3bn dollars. Moscow and Beijing have also agreed to develop a military helicopter with a carrying capacity of 15 tonnes, and a long-haul airliner; both will be manufactured in China. The helicopter project appears entirely realistic, but there are grave doubts about the airliner project.

Vietnam entered the Top 5 of Russia's largest defense customers in the early 2010s. The Russian portfolio of outstanding Vietnamese defense contracts is currently worth 5.5-6 billion dollars. By the end of this decade Vietnam will receive six *Varshavyanka* submarines under a 1.8bn-dollar contract; two *Gepard* corvettes, 12 Su-30MK2 fighters, and various other Russian weaponry. Russia will be involved in building coastal infrastructure for Vietnam's submarine fleet at Cam Ranh Bay and in setting up a repair and maintenance facility for various Russian defense hardware (the deal is worth 1.5-2.1bn dollars). The two countries are now negotiating a contract for *Su-35* fighters. Moscow believes that Vietnam will require a fleet of 24 such fighters in order to counter the capability of the Chinese Air Force.

Indonesia and **Malaysia** have long been among the traditional Russian defense customers. Nevertheless, most of the previously signed contracts with these two countries had been fulfilled by the early 2014, and there has been no information

about any new ones being negotiated. The two countries are discussing a project to set up a repair, upgrade, and maintenance center for Russian weaponry in Indonesia. Potentially, similar centers could be set up in other East Asian countries as well. Moscow is willing to give Indonesia a loan to finance continued imports of *Mi-17* and *Mi-35* helicopters, *BMP-3* infantry fighting vehicles, and *Yakhont* anti-ship missiles. Russia is also ready to offer credit financing for contracts for the *Club-M* missile complex, *Brahmos* cruise missiles, and *Igla* MANPAD systems. So far, however, Jakarta has not given any definitive answer to these proposals.

As for Malaysia, Russia is willing to supply tanks, *Buk-M2* medium-range SAM systems, *Pantsir-S1* gun-missile AA systems, and *Mirazh* and *Sobol* patrol boats. Russia's recent arms exports to Myanmar have included 20 (30, according to some sources) *MiG-29* fighters worth 500m dollars, 30 *Mi-17* helicopters, 10 *Mi-24* attack helicopters, and various artillery systems. There has been no information about any new contracts.

The potential for Russia's defense exports to the East Asian countries is limited by the following factors:

- *Beijing's goal of achieving self-sufficiency in terms of weapons systems in 2015-2020;*
- *Growing prices for Russian weaponry;*
- *Lack of a well-established infrastructure for the repair, upgrade, and maintenance of weapons imported from Russia;*
- *East Asian countries' growing interest only in the most advanced weapons systems, which makes many Russian offers uncompetitive;*
- *Growing competition with Chinese arms exporters. It has already become a serious factor in the markets of Malaysia, Myanmar, and South Korea, especially in the naval weapons segment;*
- *Russian defense industry's limited production capacity.*

RUSSIAN TRADE WITH EAST ASIA

The *Eastward Pivot* requires a substantial increase in Russia's economic ties, and especially trade, with the East Asian countries. In 2012-2013 the region accounted for just over 20 per cent of Russian foreign trade (up from 15-16 per cent in the previous decade). In other words, Russian trade with East Asia is already growing faster than with the rest of the world.

	2007	2008	2009	2010	2011	2012	2013
Trade	85.3	116.6	75.2	116.7	158.6	165.7	174.0
Russian exports	33.8	44.9	34.9	53.1	74.1	77.1	85.9
Russian imports	51.5	71.6	40.2	63.6	84.5	88.7	88.1

Table 4. Russian trade with the East Asian countries in 2007-2013, bn dollars. Source: Russian Customs Service

In absolute figures, Russian trade with East Asia stood at 116bn dollars in 2008 and 2010 (it fell to 75bn in 2009 because of the global financial crisis before recovering). In 2013 the figure reached 174bn dollars, an increase of almost 50 per cent. Most of the growth was generated by Russian bilateral trade with China (which rose by 50 per cent), Japan (17 per cent), and South Korea (13 per cent). These three countries accounted for 80 per cent of Russian trade with the entire East Asia region.

Most of the large energy investment projects in the Russian Far East and Eastern Siberia target the Chinese, Japanese, and South Korean markets. Such a state of affairs will remain unchanged for the foreseeable future because of the geographic proximity of these markets to Russia, their large size, and their dominant economic position in the region.

As for the rest of the East Asian countries, even if Russian trade with them were to show a 50-per-cent rise by the end of this decade (an unlikely scenario), the increase

in absolute figures will be only 15-17 billion dollars. This is less than 10 per cent of the current Russian trade with the East Asia region. Even though Russian trade with the ASEAN countries rose by 12 per cent in 2013, in real terms it reached only 17.5bn dollars. This is why there is no reason to expect any significant changes in the geographic structure of Russian trade with the East Asia region.

No targets have been announced for increasing Russian trade with East Asia. It is known, however, that the Russian government wants trade with China to reach 100bn dollars in 2014, and 200bn by 2020; trade with South Korea is to rise from 22bn dollars in 2012 to 30bn in 2020; with Vietnam from almost 4bn in 2013 to 20bn in 2020; and with Indonesia to 5bn dollars by 2015. If these targets are achieved – which is far from certain – the overall figure for Russian trade with East Asia will rise to 320-350 billion dollars (that includes possible increases in trade with other countries in the region). The share of China in the total figure will rise substantially. In 2013 it accounted for about 50 per cent of the total, but by 2020 this is expected to increase to 60-65 per cent.

A major concern is the negative balance of trade between Russia and China, which in the 2009-2013 determined the overall negative balance in the Russian trade with the region and was only partially offset by the trade with other East Asian countries.

	2007	2008	2009	2010	2011	2012	2013
Region in the whole	-17,7	-26,7	-5,3	-10,5	-10,4	-11,6	-3,8
China	-8,5	-13,7	-6,1	-18,6	-13,2	-16,1	-17,6
Japan	-5,0	-8,3	0	0,5	-0,4	0	6,0
South Korea	-2,6	-2,8	0,8	3,1	2,8	2,9	4,5
Other countries of the region	-1,6	-1,9	0	4,5	0,4	1,6	3,3

Table 5. Deficit in Russian trade with East Asian countries, bn dollars.
Source: Russian Customs Service

Given the inertia of the existing model of economic relations between Russia and China, the expected bilateral trade growth will go hand in hand with a rise in the Russian trade deficit with China.

One of the key obstacles to the growth of Russian trade with East Asia is that most of the Russian exports are uncompetitive. Apart from energy and weapons, there is a positive outlook for Russian sales of nuclear energy and hydroelectric energy equipment, lumber, and food. There is also a good potential for exports of satellite communication, navigation, and positioning services, and processing of Earth imaging information. So far, however, there have been no reports about any specific deals in these areas.

FOREIGN INVESTMENT IN EAST SIBERIA AND THE FAR EAST

The huge economic potential of the territories east of Lake Baikal remains untapped largely because Russia is unable to provide affordable and long-term financing for large investment projects there. In other words, Russia's Eastward Pivot is impossible without massive foreign investment in that region, especially in infrastructure projects. According to some estimates, a total of 250-300 billion dollars of foreign investment is required by 2030, including 150-170 billion in Eastern Siberia and 100-150 billion in the Far East.

Even though foreign investment in Eastern Siberia and the Far East showed rapid growth in 2010-2012, the absolute figures remained very low. The region accounted for only 10-15 per cent of foreign investment in Russia as a whole. Most of that investment was channeled into oil and gas production and the related services, rather than infrastructure, where it is needed the most. The main recipient of FDI was the Sakhalin Region, which

accounted for 77 per cent of the total figure. Almost all of the investment in Sakhalin was channeled into offshore oil and gas projects. The Asia Pacific countries accounted for less than 8 per cent of the foreign capital invested in the Russian Far East and Eastern Siberia. All the above figures are fairly representative of the general situation over the past few years, and no major changes are expected in the future.

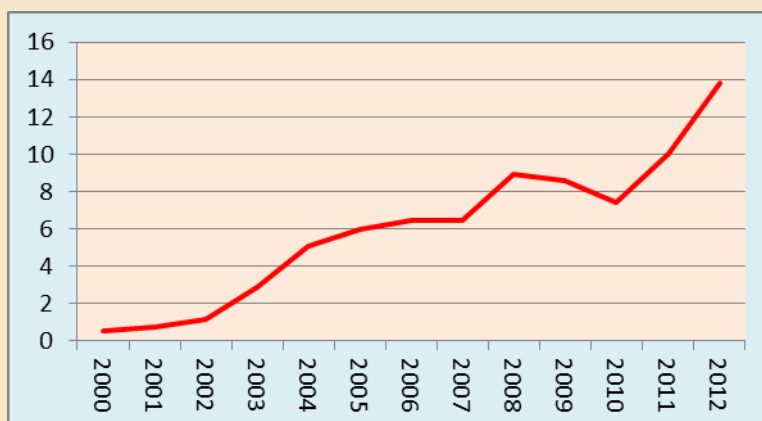


Figure 1. Foreign investment in the Russian Far East and Eastern Siberia, 2000-2012 (billion dollars, current prices). Based on open-source data.

Foreign investment in the Russian Far East and Eastern Siberia is held back by the following factors:

- **Lack of infrastructure, especially transport and communication, and high energy and transport tariffs;**
- **Lack of a proper system of investment guarantees (including a system of insurance for commercial and political risks, pledge and insurance funds, large financial institutions);**
- **Inadequate investment legislation and regulation (the taxation and tariffs system is focused on maximizing budget revenue to the exclusion of all else, with no incentives to invest)**
- **Low liquidity of companies and obsolescence of main assets reaching 50-60 per cent.**

CONCLUSIONS

- The concept of the *Eastward Pivot*, especially the parts of it aimed at accelerating the economic and social development of Russia's eastern regions, is fundamentally in line with Russian national interests. For the moment, however, the country lacks the resources required to put that concept into practice, and that is not going to change in the foreseeable future.
- There are no reasons to expect any major structural changes in Russia's economic relations with East Asia. Any large increase in Russian arms exports to East Asian customers is unlikely. Meanwhile, Russian non-weapons exports with a high added-value component are not competitive with American, European, Japanese, or Chinese exports in terms of quality (and, in the case of Chinese goods, in terms of price as well). As a result, any changes in the size of Russian trade with the Asian countries can be driven only by Russian exports of hydrocarbons.
- In practice, the *Eastward Pivot* currently boils down to building closer economic and political relations with China. This carries various risks. Chinese influence is rising fast in several strategically important Russian industries. It is not clear how Russia intends to reduce its trade deficit with China. Also, Russian policy in East Asia and several other parts of the world is already too dependent on the position adopted by Beijing. Russia itself, meanwhile, lacks any major instruments to exert influence on China's own policies.

The author of this paper is Yuri Fedorov, PIR Center's expert, member of PIR Center's Executive Board

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