

Russian Federation as Central Planner: Case Study of Investments into the Russian Far East in  
Anticipation of the 2012 Asia-Pacific Economic Cooperation Conference

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## Introduction

The Russian Far East (RFE) is currently the center of a large Russian development project as the city of Vladivostok prepares to host the Asia Pacific Economic Cooperation (APEC) Conference in September 2012. The Russian Federation hopes to use this event to introduce a renovated Vladivostok as an international hub of trade, transit, and business. The federal government of Russia has allotted over 400 billion rubles (about 13 billion USD) for developments in the city – investments that are not simply a show of hospitality to APEC Conference participants, but that are intended to cure economic depression in the region.<sup>1</sup>

The Russian Federation hopes that the demonstration of completing major projects will project a positive image of the region and will highlight potential future investment possibilities to foreign investors. However, it remains to be seen if the construction projects alone will be enough to alter the business climate, or if legislative reforms will be needed to create free market conditions necessary to attract business. Another concern is whether the RFE will be able to maintain the newly built infrastructure and if the focus on the region will be enough to increase confidence and build incentives for long term reinvestment to the region.

The Russian Federation inherited an inefficient and dependent economy in the RFE that faced many obstacles to economic reform. The poor performance of RFE industries today is due to the Soviet legacy of ignoring comparative advantage; production facilities and human settlements in the RFE were established for political, not economic, reasons. The Soviet economy was closed and did not consider the true world market costs of inputs to industry. As a result, RFE industries in the Soviet period were propped up by subsidies, and would never have

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<sup>1</sup> Using an exchange rate of 30 rubles to the dollar.

been solvent internationally. State subsidies also sustained the high costs of a large permanent population in the RFE.

With the dissolution of the Soviet Union, the Russian Federation faced three alternatives in the RFE: 1) to encourage outmigration and close marginal settlements, 2) to invest heavily in modernizing local industries to become competitive on the global market, or 3) to pursue a mix of investment and consolidation. The region was privatized during the national reform program of the early 1990s, but results were poor. The federal government was too weak to follow through on promised investment and reform. A weak rule of law, lack of social support, and decline of local industries created a prolonged atmosphere of uncertainty in the RFE. This uncertainty resulted in a poor climate for business development. The highly uncertain investment climate encouraged asset stripping and capital flight to capture the maximum present value of resources. High levels of crime and corruption, unemployment, and population outflow resulted. After two decades of decline, federal investment is now underway, suggesting that at the eleventh hour the Russian Federation has decided to pursue the option of heavy investment to save the floundering RFE.

This paper will examine the history of economic reforms in the RFE to analyze whether the investment projects surrounding the APEC 2012 conference will have a lasting positive effect in the region. Specifically, will these projects fulfill the goals of the *Strategy of Social Economic Growth of Primorsky Krai up to the year 2025* (hereafter, *Federal Strategy 2025*)? This federal program is an extensive plan for investment into infrastructure, industry, and social systems intended to create regional centers of specialization, competitive firms, and to establish Vladivostok as an international business and transportation hub. This paper will draw on official Russian regional statistics, as well as observations from secondary sources, to assess the

feasibility of creating specialized clusters of industry capable of competing with existing competitors on the Asia-Pacific market. Social indicators will also be drawn upon to assess if the investment, much of which has already been transferred, is having a positive effect on residents of the region. Ultimately, this paper will consider if the implementation of the *Federal Strategy 2025* has created a stable enough environment to create incentives for regional players to make long-term investment in the region.

Is the Russian Federation creating open market conditions in the RFE, or is the central government playing the role of the Soviet central planner – fully controlling investment projects in the RFE and diverting their returns to the center? The significance of the *Federal Strategy 2025* and the corresponding investments are best understood in context of the unique economic history of the RFE. The next chapter will provide an overview of the economic history of the RFE from the time of transition from central planning to a mixed market economy.

## **Chapter 1: An Economic History of the Russian Far East**

The dependence of the RFE on imported goods and federal subsidies made the region uniquely sensitive to the state withdrawal upon the fall of socialism. Soviet Central Planners favored center-periphery relationships over regional ties in order to foster dependence directly on the center. This left Russian regions without horizontal integration and dislocated from distant markets in central Russia. The end of federal subsidies meant economic isolation.

The RFE was ill-prepared for the coming economic shocks of transition. The erratic financial climate during transition gave people incentives to maximize short-term profits, to ship profit overseas, and to emigrate themselves when possible. Weak government could not provide a stable economic climate or social guarantees. On the ground there was little ability to enforce contracts and ownership rights. Agency problems and missing institutions exacerbated the focus on the short-term. The future consequences of over utilization of natural resources and capital flight were ignored in the struggle for survival. To evaluate the progressive nature of the current reform projects, it is first necessary to identify and describe agency problems and weak market-supporting institutions that have persisted to the present period.

Debate over the correct direction of reform and over consolidation of political power led to conflicts at the federal level during the early 90s. The inconsistent access economic reformers had to political power manifested in incomplete and distorted reforms. Price liberalization and privatization were the first two major reforms to have a lasting effect on the Russian economy.

Price liberalization was intended to adjust Russian prices to world market levels and to integrate Russian firms into international markets. This process began in the early 90s, but was implemented gradually to reduce shocks (oil and gas, for example, were excluded from price

adjustments). Despite price liberalization, macroeconomic stability remained elusive. Excessive issuing of credit and the lack of an accountable banking system held this goal hostage. Central government officials appeased profitable, central industries to retain political support. Meanwhile, those who controlled access to resources stymied reform, seeking to retain their privileged positions. Legal and financial reform lagged behind basic economic restructuring. The lack of deterrents to illegal behaviors – and the ambiguous definitions of legality - created opportunities for rent seeking and incentives for asset stripping and capital flight.

In the absence of Soviet subsidies, local money supplies disappeared. Across Russia the short-term solution was to borrow from the central bank to maintain former levels of financing. In early transition the central bank head, Gerashchenko, simply increased central loans to allow inefficient production to continue. Money supply expanded in coincidence with contracting demand, causing hyperinflation. Hyperinflation was the result of reformers having inadequate control of financial institutions. Reforms were not comprehensive (i.e., price liberalization accompanied expanding credit) and results were perverse. In the far-flung RFE a wildly fluctuating financial climate emerged characterized by uncertainty, weak rule of law, unofficial markets, capital flight, and the failure to maintain declining industries.

Hyperinflation was uniformly destructive to industries of the RFE, the destructive element being the inability of Russian industries to make necessary fixed capital investments to become competitive on the world market. The inability of the center to address realities of life in the periphery often exacerbated regional difficulties. Industries lost government subsidies and had limited access to credit or outside investment to replace their major source of income.

Poverty multiplied in the RFE when money supply did not expand in step with skyrocketing prices. During transition the regional government inherited “90% of the costs of healthcare, welfare and education,” extensive systems that were centrally financed during the Soviet era (Thornton & Ziegler, 2002). Lacking the resources to support these institutions, social services decayed. Over 46% of residents fell below a poverty line that had already been reduced to minimize the official scope of the problem (Chang, Winter 1999, pp.108). A basic food basket of 19 items cost 63% more than the Russian average, yet new tariffs on imports to the Russian Federation were introduced at the demand of central Russian farmers (Chang, Winter 1999, pp. 106).

Such reforms indicated how dislocated the RFE was from Moscow. Residents realized they could not rely on central support and turned to local mechanisms of authority and enforcement. The central and regional governments began to struggle for control and cash flow rights over local resources as regional actors sought to direct revenues to themselves. Regional producers and political elites had little confidence in the future of the Russian state and lacked authority to implement necessary reforms or establish long-term investment projects.<sup>2</sup>

Meanwhile, as price controls were lifted, Russian firms found final world market value of their products was less than the cost of inputs for production. Negative value-added products in the fishing, forest products, chemical and light industry sectors and unprofitable agricultural, ferrous metals, and coal sectors indicated the need for modernization in sectors that had some comparative advantage (Thornton & Ziegler, 2002). As local industries became increasingly

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<sup>22</sup> This was due to the Soviet tendency to encourage regional dependence directly on the center; the regions inherited no horizontal linkages with one another and were unable to capitalize on comparative advantage between regions to achieve efficiency in trade. When regions inherited the ability to determine their own investment projects it was not uncommon for projects such as a road leading to the end of one region, stopping at the border of the next, to be realized (Gaddy, 2003, pp. 112).

unprofitable and difficult to sustain, hyperinflation lowered living standards in an area disproportionately reliant on imported goods to meet basic needs. With no incentive to invest in the region, export markets grew and profits followed the goods overseas. Asset stripping and capital flight became pronounced in the RFE, an indicator of the poor economic climate that persists to the current period.<sup>3</sup>

The local patronage network surrounding Primorsky Krai Governor Yevgeny Nazdratenko, emerged as the new local power structure in the immediate post-Soviet period. Nazdratenko openly quarreled with Yeltsin over political reform and over control of local resources. He justified regional autonomy by pointing to the inability of the RFE to subsidize federal programs with high taxes while experiencing devastating poverty locally. The drive for local control of natural resource revenues was not altruistic – greater regional control gave Nazdratenko access to resource rents and opportunities to enforce his patronage network through corruption and cronyism (Chang, Spring 1999, pp. 258). Moscow became skeptical of sending any money to the region as “transfers had a dismaying record of going astray once they reached Primorsky Krai” (Chang, Spring 1999, pp. 261).

Squabbling between Nazdratenko and Yeltsin prolonged negative aspects of transition. Orders from the center were deliberately ignored or subverted locally, local authorities pilfered funds, enforcement agencies became increasingly corrupt, and crime proliferated. As the administrative and legal structures were widely known to be corrupt, residents in the region turned to unofficial power structures, allowing for the rise of large organized crime and mafia syndicates during the 90s.

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<sup>3</sup> Capital flight is a persistent problem across Russia and indicates that underlying economic problems have yet to be addressed.

The RFE had inherited a large Soviet military industrial complex that was impossible to transition to other purposes considering the lack of available funds and lack of business ties. Whereas half of the RFE's production under Socialism was military related, the region's physical isolation, lack of funding, and distance from research and development led those formerly engaged in Soviet military endeavors to resort to any means possible to earn money. Weapon sales to China were one short-term solution, but former military and federal employees no longer receiving their paychecks gained new incentives to participate in unofficial enforcement activities.<sup>4</sup> As relaxation of regulations on private business began in 1991-1992, mafia-like protection structures began to emerge, especially in the RFE (Aslund, 2007, pp. 42).

Russian reformers were aware of the anomalies in economic reform. One major goal of the privatization program, the first step in restructuring Russia's economy, was to address these by ending political control of economic institutions and by providing fair entry to market capitalism. Breaking political control of economic decisions would also enable unified reforms to move through the legislative system.<sup>5</sup> The necessary basic change was to align control and cash flow rights over resources into private ownership. Hard budget constraints would introduce normal incentives towards meeting actual supply and demand and would foster appropriate levels of investment and risk taking.<sup>6</sup>

Privatization was successful at the national level. "Over 14,000 firms employing two-thirds of the industrial labor force were privatized...during a brief yet tumultuous 20-month period of countless parliamentary battles, several cabinet shake-ups, a hotly contested

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<sup>4</sup> Weapon sales to China were short-term because China was able to reproduce Russian proprietary technology.

<sup>5</sup> As opposed to disjointed reforms that prolonged transition, and prolonged opportunities for massive rent-seeking due to contradictory and inefficient legislation.

<sup>6</sup> Political actors, and those not immediately affected by loss resulting from high risk behaviors, are more likely to engage in them. Political actors may pursue objectives besides economic efficiency and value maximization to gain support of special interest groups or to maintain political power. See Stiglitz for a complete discussion.

referendum on economic reforms, an attempted coup, and an election that reformers lost” (Boycko, Schleifer & Vishny, 1995, pp. 110). Privatization of firms in the RFE had less impressive results. At first “voucher auctions were attempted, but then stopped after outside investors in some companies bought enough shares to oust the incumbent managers. The government of the region reacted by reversing privatization, and putting all regional firms into a holding company it controlled” (Aslund, 2007, pp. 110).

Small-scale firms were largely privatized, but workers fearing change reelected Soviet managers. This meant no change to organizational structure and a continued reliance on production plans rather than on consideration of actual demand. The failure to consider demand in production decisions exacerbated the lack of capital. Managers of newly private firms continued to behave as if they did not face hard budget constraints and wasteful overproduction drove capital shortage in the RFE to the extreme. Unofficial markets flourished and many transactions were based on barter and arrears systems (Thornton & Ziegler, 2002).

Without the ability to improve on industry and raise capital by legitimate means, those with control rights to resource-based industries had incentives to exploit the resource base without considering the long-term. Natural resource industries had additional pressure to make up for the drop in industrial production, and overexploitation abounded (Bradshaw, 1998). Capital flight replaced fixed capital investment and existing facilities withered. Capital flight was especially pronounced in resource markets with easy access to foreign markets with high demand.

A prolonged decline in the agricultural sector raised the reliance on imported foodstuffs. Agricultural firms were privatized, but remained massive enterprises that leveraged official

collective ownership to ignore personal aspects of ownership (Duncan and Reutschle, 2001). The failure of restructuring in the agricultural sphere led to impoverishment of small farmers and insolubility of large agro-enterprises. The availability of low cost, higher quality foreign imported agricultural products limited the market for domestically produced goods (Duncan and Reutschle, 2001, pp. 97). The costs of energy to agriculture soared as agricultural complexes had been built in the Soviet period without consideration of proximity to energy sources. The negative effects of high energy costs extended across all industries, who struggled to pay energy bills and placed an increased burden on households.

Industries in the RFE now had direct control over international trade relations, but foreign capital did not pour in as Moscow had hoped. Asian Pacific markets became aware of the poor quality of enforcement and administration in the RFE and preferred to develop local industries. Russians perceived foreign involvement as “selling of their patrimony” and the business climate for foreign investment became hostile (Chang, Winter 1999, pp. 110). The lack of a modern banking system, risk of appropriation, unpredictable regulatory system, and absence of a reliable judiciary mechanism detracted from the appeal of business opportunities for foreigners in the RFE. It was difficult even for Russian companies to survive.

Economic reform stalled in the mid-90s as Yeltsin pandered to the newly emergent oligarchs to maintain political power. Prolonging uncertainty benefitted rent seekers and the political elite, but had severe consequences later on. The pegged ruble exchange rate, high levels of foreign investment, and high levels of capital flight contributed to Russia’s eventual economic collapse.

During the mid 90s, the federal government began to address non-payment issues by scaling back the amount of credit issued and increasing taxes. Increasing taxes did not address the lack of money to pay them, and led to enforcement issues with tax collection in the RFE (Chang, Winter 1999).<sup>7</sup> To reverse revenue flows, Moscow tightened restrictions on state-issued credit as taxes increased. The presence of tax collection officials increased to foster adherence to the new tax legislation. These policies further strengthened the unofficial economy; barter and promissory notes increasingly replaced hard currency as the medium for business (Chang, Winter 1999, pp. 80). Transactions were kept entirely outside of official records to circumvent the onerous tax code, and profits were shipped overseas to avoid the perceived domestic instability. Crime and corruption flourished as enforcement officials kept tax payments in lieu of receiving their formal salaries. This top down approach failed to address the causes of non-payment and inadvertently reinforced incentives to avoid the official tax structure.

In the RFE, tightening of credit led to pronounced capital shortages. Increased transport costs for imports from Europe and Siberia were passed directly to consumers and although the government kept energy costs artificially low, energy prices were forced to incorporate the increased costs of transportation (Bradshaw, 1998, pp. 1053). Low worker productivity and increased cost of inputs made it difficult for production in the RFE to compete with other Russian regions, and hence, the region lost a share of the domestic market (Thornton & Ziegler, 2002). High input costs and lack of capital on the Russian side paired with high prices for raw natural resources on the world market moved comparative advantages for value added industries outside of Russia.

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<sup>7</sup> By 1990 there were 200 taxes in Russia (Chang, Winter 1999).

Agricultural reforms subsequent to the initial privatization, when most agricultural land became property of the state, made leasing laws oblique and credit nearly impossible to obtain. The result mirrored the nationwide tendency for agricultural productivity to be highest on private household plots, the plots that sustained much of domestic consumption (Ioffe, Grigory, Nefedova, and Zaslavsky, 2006). According to a 1997 research study by the Rural Development Institute, household plots were the “only sector in which a nearly functional land market is emerging in the RFE” (Duncan and Ruetschle, 2001, pp. 101). It was illegal to transfer land between uses, meaning agricultural lots remained fixed in remote areas with inherently high transport costs. The availability of cheap Chinese agricultural products made it nearly impossible for Russian agriculture to compete. With little access to credit, insecure land ownership/leasing rights, restrictively high taxes, inability to afford necessary equipment, and the arbitrary nature of law enforcement, many small farmers segued into other industries or moved into Russian cities (Duncan and Ruetschle).

Foreign and foreign-assisted firms in the RFE during the mid 90s demonstrated the difficulties of establishing a successful operation even with investment and council from successful business partners. The experience of the Vostochny International Container Services (VICS) indicates how even with foreign investment, one efficient firm would not be able to remain profitable in a vacuum; VICS could modernize its own port infrastructure and management, but it would be impossible for the firm to finance infrastructure across Russia (management, communications, roads, ports, etc.) necessary to lower costs (Mikheeva & Thornton, 1996). Problems with asymmetry of information and weak institutional enforcement led to rent seeking activities. Operating costs remained so high that foreign investment in the region was mainly attractive to international conglomerations that could afford to trade a

financial loss in the RFE for increased prestige through ability to serve the area. As exemplified by VICS “efficiency gains mattered little if contracted revenues didn’t even cover contractual operating costs” (Thornton & Ziegler, 2002). Widespread structural change was needed from the bottom up in order to meaningfully change the business climate of the region.

The strained business climate soured attempts to integrate economically with other Asia-Pacific countries. In the 1990s Russia envisaged “its role in this new order as a supplier of natural resources (minerals, energy, timber and fish) to the industrializing Asian markets,” but the lack of existing infrastructure and restrictive economic legislation prevented the RFE from fulfilling this role (Bradshaw & Lynn, 1998, pp. 383). Competition was new to the Russian market and was dampened by legislation restricting entry or granting monopoly rights over strategic industries (Aslund, 2007). China emerged as the primary trade partner of the RFE, but trade with China consisted of importing consumer goods and not the large-scale investment projects hoped for to bolster future growth of the region.

Chaotic leadership in the region had negative effects on relations with Asia-Pacific neighbors as well. A surge in illegal Chinese migration into the RFE led Yeltsin to negotiate tougher visa and immigration standards with China in 1994. Locals resented the increased Chinese presence, but this action resulted in a nearly \$1 billion annual trade revenue loss (Chang, Winter 1999, pp. 84). Seeking to assert political dominance, and pandering to local xenophobia, Nazdratenko subsequently made a unilateral decision to deport about 11,000 Chinese immigrants (Chang, Winter 1999). These actions reinforced perceptions of instability in the RFE abroad. Neither the federal nor regional government took a long-term stabilizing view towards encouraging cultural understanding to ease Russian-Chinese relations, indicating the failure of political agents to invest in the long-term economic health of the region.

In 1996 the central government introduced the *Federal Government Program for the Economic and Social Development of the Russian Far East and Transbaikal from 1996-2003* (hereafter *Federal Program 2003*). Goals of the program were to eliminate preferential treatment of federal employees, reduce crime and corruption, raise living standards to create a stable population base, split apart monopolies, establish a healthy export market for natural resources, and integrate economically with the Asia Pacific region. The solutions suggested were increased investment to the region, which the federal government could not afford, reflecting the gap between federal government rhetoric and reality.

Poorly maintained and out of date equipment, lack of (integrated) infrastructure, inefficient Soviet style management, and continued struggles with non-payment and labor disputes continued to plague the region. Gasification of the RFE was a goal of the 1996 program, but this endeavor required a large amount of capital investment and foreign expertise, making it a distant future goal. Energy, namely the sale of oil on the world market, remained the driving force of the Russian economy.<sup>8</sup> Estimates of available resources in the RFE suggested that oil and gas reserves were underutilized. Western skeptics questioned whether the cost of extraction would forever outrun potential profits from natural resource extraction in the RFE; however, the proximity to potential Asian markets kept interest in the possibilities alive (Bradshaw, 1998).

These reforms ignored the question of whether it was cost-effective or otherwise necessary to maintain a large settlement in the RFE. The wealth of the region's natural resource base was questionable (especially considering high input and labor costs), the perceived need to maintain a large military presence had evaporated, and living standards remained low (Bradshaw

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<sup>8</sup> Anders Aslund asserts in *Russia's Capitalist Revolution* (see bibliography) that oil prices remain the determinant of Russian reform policy; in flush times with high oil prices the government will be free to centralize power without consequences, when prices drop meaningful reforms are discussed in order to appease the population.

& Lynn, 1998). Government orders for the region to subsidize energy supply to federal offices without making corresponding payments led to strikes that disrupted regional energy supply systems in the 1990s (Gulidov, Kalashnikov & Ognev, 2011). Federal involvement in the region met minimal acceptable standards rather than the inflow of federal investment suggested in the reform program. Unsurprisingly, “most of the reform measures initiated by the governmental commission... were systematically undermined or simply ignored” (Bradshaw & Kirkow, 1998, pp. 1054). Investments were not followed through with and the *Federal Program 2003* “in no way stimulated development” (Thornton & Ziegler, 2002, pp. 113).

Federal reform became more responsible and unified after the financial crisis of 1998, when Russia defaulted on its loans and hyperinflation returned, reaching 400% in the RFE. After this shock macroeconomic stability was given priority. Paired with high oil prices in the late 90s, economic stability began to emerge. Putin came to power in 2000 and began to establish his power vertical. He also began to introduce elements of a market economy into Russia (Aslund, 2007). At a time of high oil prices and macroeconomic stability, Putin was able to secure political control and offered confidence in the future of Russia.

Previously, Primorsky Krai received more federal transfers than any other Russian province, but there was no evidence that these funds improved economic conditions. Putin himself admitted that “of 14 billion rubles allocated to the region in the 1999 Russian Federation budget, only 1.5 billion were actually spent for the region’s benefit” (Thornton & Ziegler, 2002, pp. 7). Putin maintained minimally acceptable standards for the existing military and met the basic needs of the existing population of the region by providing access to fuel, heating, drinking water, transport and communication systems, minimal education and healthcare (Bogaturov,

2004, pp. 86). These subsidies were not on scale with the investment promised by the *Federal Program 2003*, but they were immediately tangible and soothed the local populace.

Minimal investments were not, however, sufficient to make the region appealing for investment or to address problems with industrial debt or the lack of working capital. For example, agriculture in the RFE still lacked the necessary infrastructure, subsidies, and storage facilities to give it any kind of comparative advantage. Even joint-venture agro-firms that had received loans from their foreign counterparts to purchase necessary equipment suddenly found their debts multiplied to insurmountable levels (Duncan and Ruetschle, 2001).

Another continued detriment to foreign investment was Primorsky Krai's notorious corruption. One Vladivostok businessman commented in 1999 that "...the city's development would depend too heavily on bribing the right people" (Chang, Winter 1999, pp. 103). A Western investor noted that moving freight through customs "...meant endless headaches brought on by interminable delays, extortionists, petty thieves, and small-minded bureaucrats" (Chang, Winter 1999, pp. 104). It was clear that legislative reforms were needed to establish a favorable business climate before any amount of investment could make a potential long-term positive impact on the region.

By the time of Putin's reelection, central control had been established thoroughly throughout the Russian Federation. Putin began reasserting federal control by removing Nazdratenko from power in 2001 and replacing him with Sergei Darkin, a Putin supporter guaranteed to be accountable to Moscow.<sup>9</sup> This reduced a large destabilizing factor in the region as "Nazdratenko proved that the problem of the RFE region is not a lack of resources... The

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<sup>9</sup> Nazdratenko was given the position of head of Ministry of Fisheries where he maintained power and influence by controlling allocation of access to fisheries resources.

problem is that they enrich a significant segment of regional elites, not governments” (Bogaturov, 2004, pp. 85). Nazdratenko’s departure ended a period of direct insubordination by the leader of Primorsky Krai. Putin’s vertical power structure ensured that the governor would submit to Moscow and a federal representative was assigned to oversee the district, but these new positions replaced the patronage system rather than destroyed it. In fact, the process of vertical integration of power immediately came in conflict with reform proposals for the RFE as kickbacks and privilege were necessary to control new local political elites (Thornton & Ziegler, 2002).

Central control was expanded through appointing federal representatives to the regions and by a new tax code in 2005 directing 80% of taxes on natural resources to the federal budget and 20% to the regional budget (Thornton & Ziegler, 2002). Federal dialogue and recognition of social and economic problems in the RFE was thereafter limited to extending the Federal Program 2003 from year to year. The primary goals of the program remained the same, and the federal government continued to neglect to follow through with promised investments, though Russian reserves from the sale of oil made federal investments possible.<sup>10</sup>

However, some important precedents were set for foreign investment in the RFE during this period. In 2006, after the Russian federal government began ratcheting up environmental concerns and made clear the relation between Russia’s resources and national security, Royal Dutch Shell was pressured to sign a majority stake of the Sakhalin II investment project to

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<sup>10</sup> This has been and continues to be a hallmark of the Putin/Medvedev era of Russian politics; sweeping reforms are suggested by politicians, but actual reform, innovation, or easing of the business culture has been achieved. The World Bank *Doing Business in Russia* report and the Transparency International Corruption Perceptions Index (see works cited for full citations) are useful references that measure national and international perceptions of the Russian business climate and provide analysis of the functioning of the regulatory structures governing development and investment of the Russian economy. Both indicate that in recent years the business climate has remained poor and there are no signs of improvement for the future.

*Gazprom*. After this agreement came into place environmental issues disappeared from public discourse, and Putin announced that they had been resolved.

This action had several broad implications. Energy projects in the RFE require unprecedented levels of investment. The Sakhalin II project in 2006 was estimated to spend \$100/bbl on development and “cost overruns were a result... of underestimating the scale of the challenges involved in developing an integrated oil and gas project from scratch in such a remote region of Russia” (Bradshaw, 2006, pp. 13). The appropriation of the majority stake by state-owned *Gazprom* indicated the risk of large-scale investment into Russia and discouraged risk-averse investors. Secondly, the extremely high costs of development in a region with little established infrastructure led investors to look to more cost-effective regions. In this sense the appropriation reveals the focus on short-term benefits over long-term growth by Russian leaders. In 2007 ExxonMobil was forced to renege on contracts to sell gas from Sakhalin directly to China and instead sell gas directly to the state monopoly *Gazprom* for further distribution, subordinating ExxonMobil to *Gazprom*'s purchase terms (Partlett, 2012). Most importantly, these developments indicate that the Russian government continues to view natural resources as federal property and, as the majority of the related revenues are returned to the center, resource-based developments have little potential to be significantly beneficial at the local level.

Russia does not possess an independent base of technical experience capable of undertaking oil and gas extraction projects without foreign assistance. Foreign partners are also necessary to lessen initial costs and because, while Russia is expanding into new markets its partners have already established favorable reputations globally. While major oil companies continue to display interest in expanding into Russia “the question remains whether or not the Russian government and the companies it controls can create the kind of business environment

needed to convince those foreign investors that they will get an adequate and secure return on their investments in Russia without damaging their reputation” (Bradshaw, 2006, pp. 14).

The difficult business climate remains the primary obstacle to economic growth in the RFE. Inconsistent relations between the region and Moscow have led regional actors to be continuously uncertain of the future of support from the center. This uncertainty manifests in incentives to maximize short-term profits. In order to effectively reform the regional economy, steps must be taken to realign incentives with reinvesting in the region for long-term growth. Unemployment in the RFE remains high and social support is lacking. The infrastructure needs modernization in order to compete with or participate in everything from modern financial markets to modern logistics management. The next chapter will explore the present economic structure of Primorye to provide the contemporary context for the current reform program.

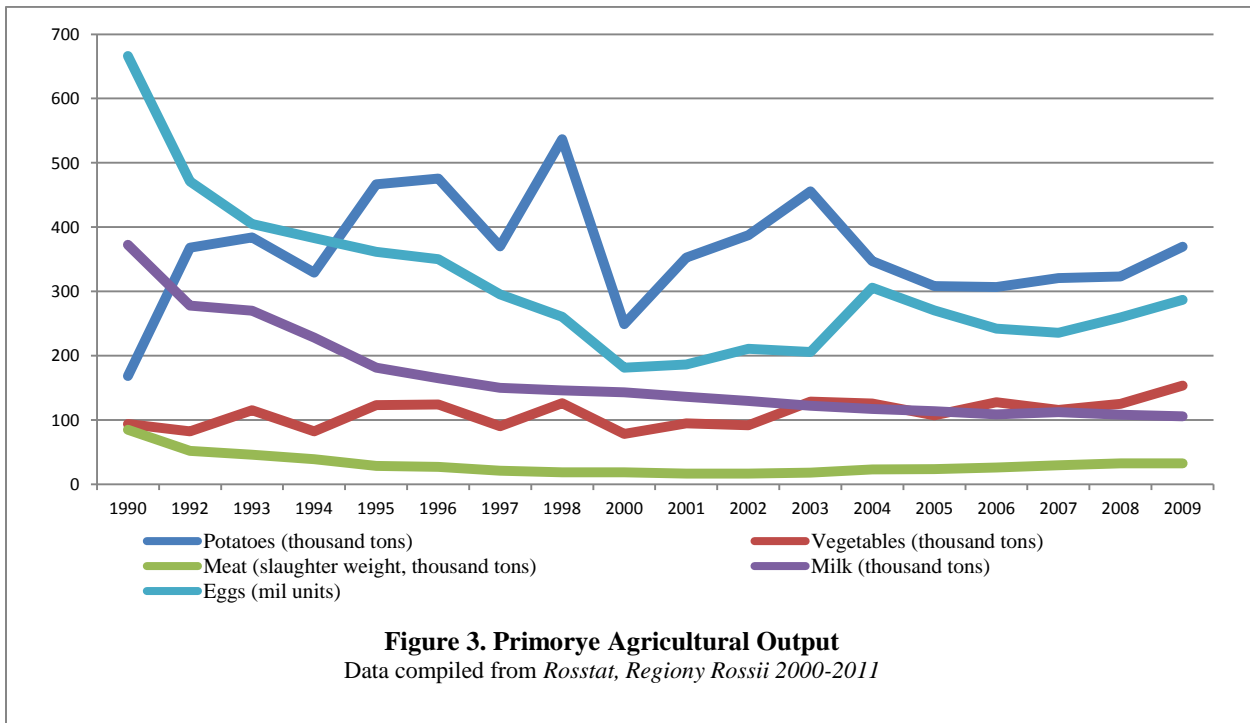
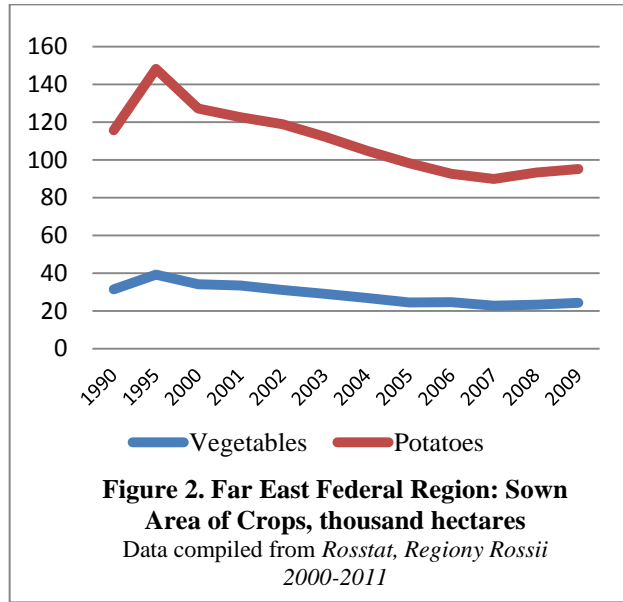
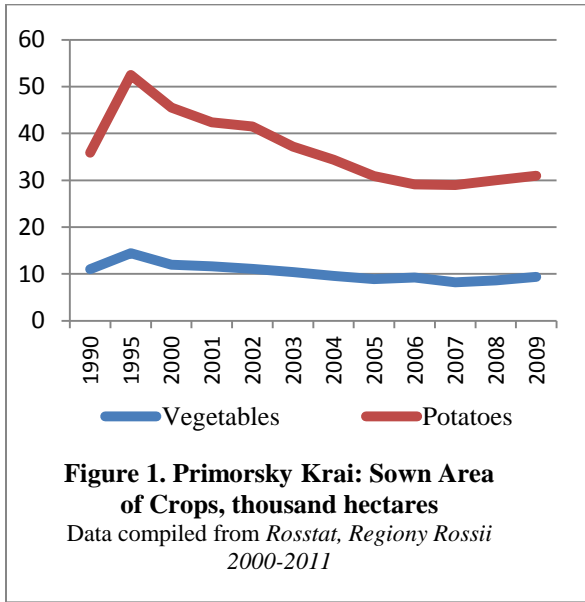
## **Chapter 2: Primorsky Krai Today**

The economic structure of Primorsky Krai has transformed as traditional industries fragmented during the transition period. The Pacific fleet entered disarray, fisheries fell to disrepair, shipbuilding and repair enterprises lost their business to illegal offshore landings, and only one of 32 military enterprises successfully transitioned to civilian production (Thornton, 2011). Primorsky Krai had formerly been the most productive agricultural area of the RFE, another area of decline (Duncan and Reutschle, 2001). Today the majority of profits are accrued through the sale of raw, unprocessed natural resources. These resource industries continue to lack adequate capital to maintain and improve on existing facilities and are thus somewhat far from the ultimate goal of creating local processing plants.

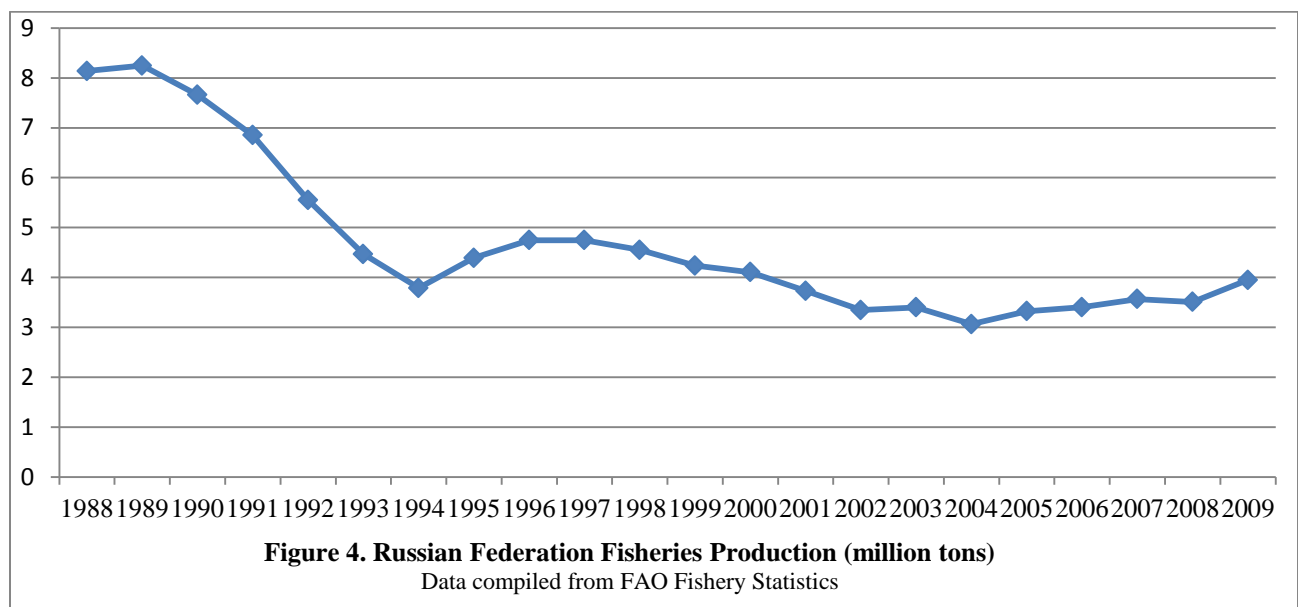
Agricultural production has been in constant decline and the federal government now leases land along the Russian border to be farmed by migrant workers. This is due to the greater productivity of migrant workforces and the greater harvest yields they procure (Duncan and Reutschle, 2001). In 2007 lands tended by Chinese demonstrated yields two times higher than the regional average (Rotering, 2008). A federal agricultural reform program of 2004 intended to “regionalize” agriculture shifted the burden of financial support and administration of federal laws to the regions (Russia Agriculture Policy Review, 2007). The process of splitting administration between the region and the center resulted in confusing agricultural laws and left the RFE to struggle with a new financial and administrative burden. According to leaked US Consulate correspondence, this burden falls to local farmers, who face high costs of energy and equipment (Rotering, 2008).

Declining investment in agriculture and the diminishing scope of agricultural activity in the RFE create an increased demand for and reliance on Chinese imports. Chinese fruits and

vegetables are available year round, whereas local farms produce these only in the summer (Rotering, 2008). The lack of easy credit available to farmers, lack of property rights to land, high start up costs for agricultural endeavors, and the close proximity of low cost Chinese agriculture have resulted in the decline in production illustrated in Figures 1-3 below.

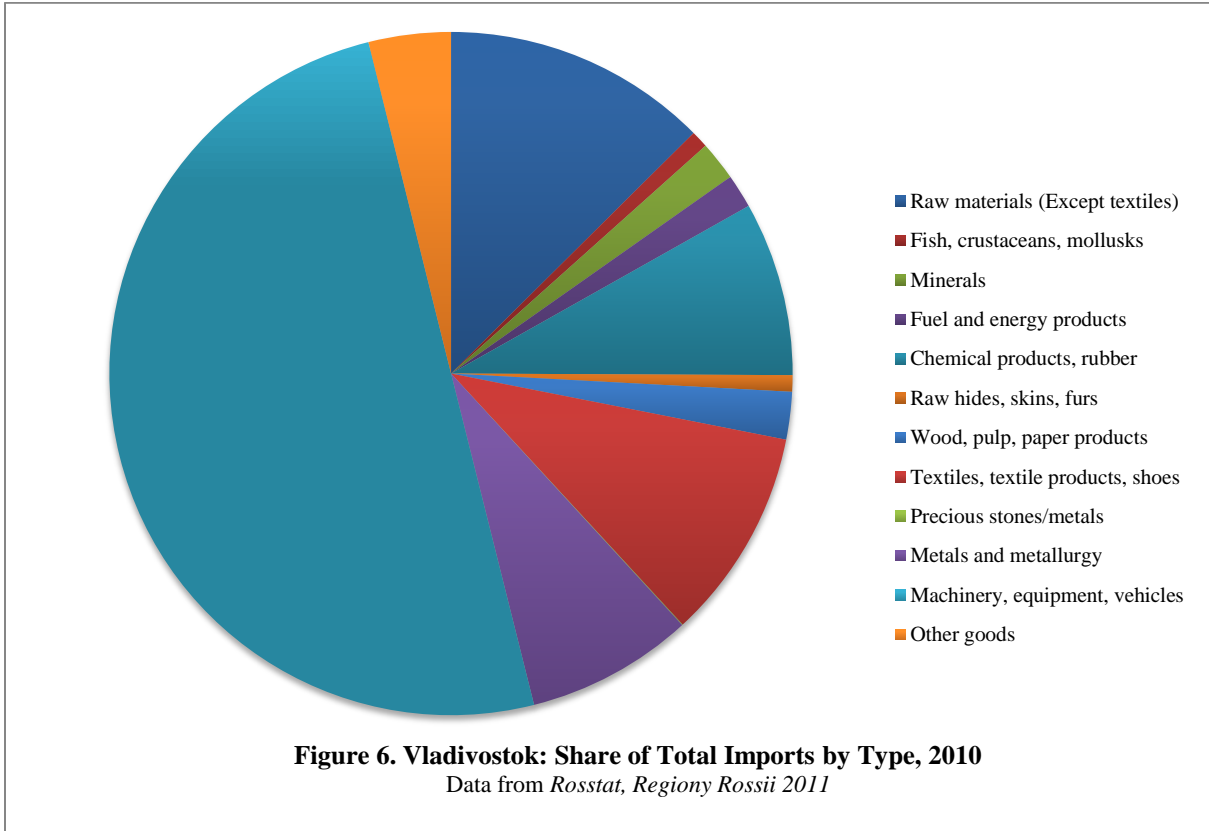
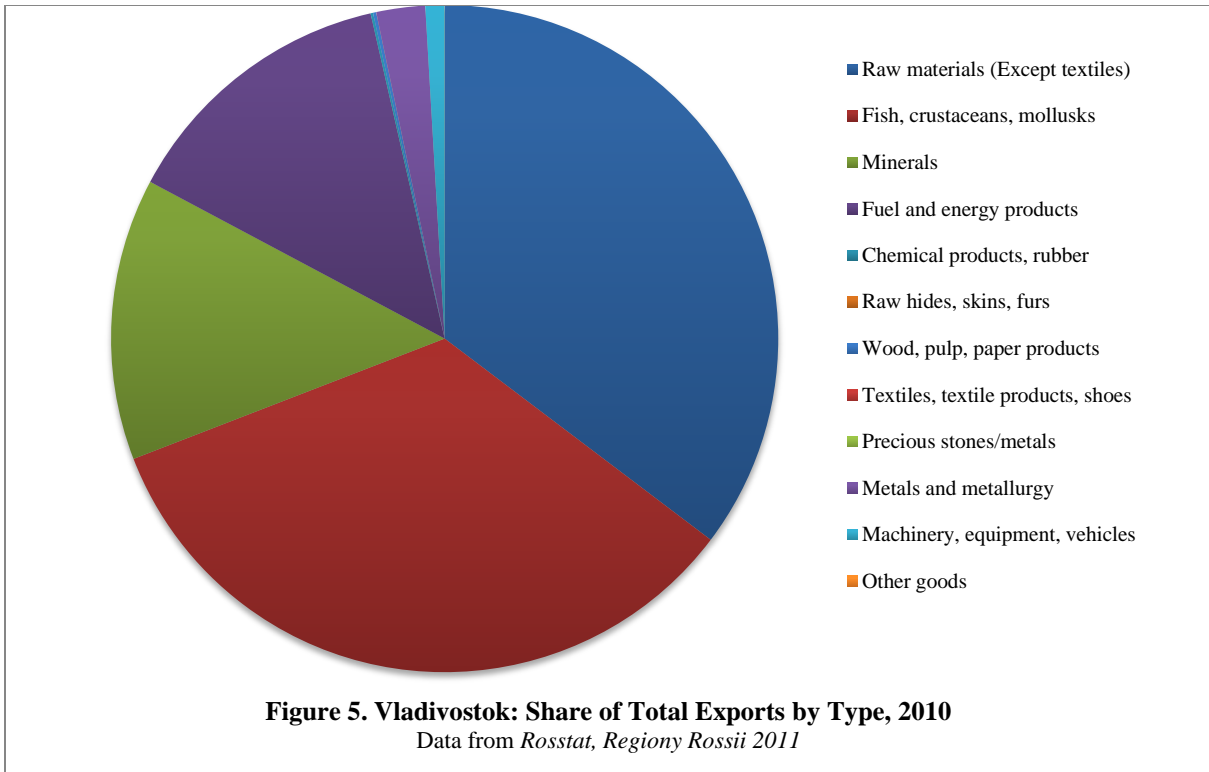


Although fisheries administration has stabilized since the chaos of transition, enforcement remains weak and segmented; Russian fisheries are openly acknowledged as a corrupt sector. High demand from neighboring countries and high profits made through illegal offshore landings create strong incentives to avoid local taxes and customs payments. According to a leaked US diplomatic cable, fisheries continue to operate on a well-established shadow market: there are known, set prices for smuggling different quantities of fish products through the local militia (Armbruster, 2009). Russian Fisheries Minister Andrei Krainiy has stated, “There are no poaching operations without official ‘*krysha*’ and all poachers receive some kind of protection from *Rosselkhoznadzor*, the Interior Ministry, the Border Guard Directorate or other agencies” (Armbruster, 2009). Past restructuring and splitting of the enforcement authority in fisheries created a system of conflicting laws under which laws and legality are difficult to enforce. Ecological consequences of years of overfishing have also led to decline in the Russian fisheries. Total production of the Russian Federation fisheries is shown in Figure 4 below.



Fisheries also suffer from the high input costs of energy, which in the mid 2000's accounted for up to 40% of the selling price on domestic markets (Johnson, 2004, pp. 17). This problem has persisted into the present period. As the state owned Russian Railways is the monopoly owner of the only feasible transport route to central Russia from the RFE for seafood products, producers are held captive to their price demands and availability. In 2009 an unusually large catch, paired with inadequate availability of cold storage transport and a subsequent conflict between fisherman and the railways, led to mass spoilage of salmon that could not be stored or shipped (Zaytsev, 2001). This problem illustrates the lack of storage and processing infrastructure in the RFE. Fixed capital investment into fisheries could benefit the region by developing the base of comparative advantage – processing operations near to Russian ports from which Russian products could easily be sold on the foreign market would boost the local economy and provide employment opportunities. However, as uncertainty and negative perceptions of the fishing industry perpetuate, the incentives of those involved in this industry remain focused on short-term investments and returns.

A healthy forest product industry is another potentially large source of employment in the region. In 2010 Primorsky Krai exported about \$383 million in forest products, an interesting fact when juxtaposed to the need to import most building materials for APEC Conference related construction (Popova, 2012). The import/export structure by type of good from Vladivostok in 2010, Figures 5 and 6 below, show that the majority of exports are remain raw, unprocessed natural resources; this means that Russia is failing to secure value added services to the Russian side.



The import export balance indicates that the comparative advantage of the RFE is the export of unprocessed natural resources. Social welfare could be increased by capturing more of the value added services on the Russian side of trade to direct a greater proportion of the end profits of processed goods locally. Trade in natural resources also risks falling into the persistent shadow market in the RFE - a worse fate from the standpoint of social welfare as none of the profits are paid into taxation that benefits the social welfare systems. In a 2004 study of the forestry sector, Alexander Sheingauz estimated that the shadow market accounted for about 40% of the whole economy (2004). Despite attempts of the regional government to establish social safety nets, illegal activity is often the only way local people feel they can benefit directly from the resource industries.

The energy industry has developed uniquely, struggling less with lack of subsidization during the transition period because foreign investors have consistently been interested in the enormous potential profits of tapping into Russia's natural gas and oil reserves. Despite this interest, the stakes remain incredibly high. This is due not only to the harsh climate in the RFE that drives up production cost, but also to the risk of government appropriation. Federal law currently declares all subsoil mineral reserves to be strategic assets belonging to the Russian Federation, yet large-scale development projects in the oil and gas sector in Russia do not take place without substantial foreign investment and expertise. In turn, profits from investment into oil and gas extraction accrue to state-owned corporations, notably *Gazprom* and *Rosneft*. The pipelines and railroads necessary to transport these goods are also state-owned conglomerates (*Transneft* and Russian Railways respectively). The continued economic depression on Sakhalin Island, home to the most successful natural resource venture in the RFE, is an example of the

extent that investments (which in the case of the planned LNG processing plant in Vladivostok are projected to reach \$7 billion) benefit the local population.

At the most basic level, the continued outflux of population from the area suggests that residents do not feel their living standards are improving enough to invest in the area. As the “average real wage in large Siberian and Far Eastern cities has remained less than half of the average wage in cities in European Russia,” it makes sense that residents of the Far East are looking for more promising situations (Thornton, 2011, pp.17). News reports from the region suggest dire conditions for lower income segments of the population. For example, a local morgue was defrosted in March when a resident stole pipes from the refrigerating system to sell to the scrap metal yard next door (Man Nabbed, 2012). Local news sources frequently report cases of bribery, such as the embezzlement of millions of rubles from regional budgets and bribery by police officials.<sup>11</sup>

Federal reforms disrupted a mainstay of the RFE economy again in 2008 when tariffs on imported automobiles were increased to promote the Russian automobile industry. This caused anger in Primorye, where importing used Japanese cars had become a lucrative venture for Russian entrepreneurs. In 2008 half a million used Japanese cars were processed by customs in the RFE and estimates placed every 1 in 3 employed person as having a direct tie to the auto industry in the region (Kalachinsky, 2010, pp. 3). As imports dropped to 1/20<sup>th</sup> of their former volume protests began to spread across the RFE as residents felt disregarded by their own government (Kalachinsky, 2010).

The federal government refused to repeal these measures, encouraging a shift to unofficial markets. It is widely acknowledged that cars are illegally imported and delivered to

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<sup>11</sup> See Politaev, 2012 for a discussion of regional embezzlement; Kalachinsky, 2010 for a general discussion of corruption in the region; Vladivostok Police, 2012.

local markets without paying customs.<sup>12</sup> The scheme illustrates how regions continue to deal with unfavorable federal policy by shifting to unofficial markets.

Moscow has attempted to address this unrest, and to replace local jobs, by pushing the auto assembly company, *Sollers*, to move production to the RFE. *Sollers* moved its production plant to Vladivostok at a high cost, and produces automobiles in the Far East that are primarily sold in western Russia. The Russian federal government subsidizes transportation costs for the vehicles (thereby distorting actual input costs). *Sollers'* Far East Director Alexander Korneychuk has expressed doubt over whether these actions will support long term expansion of auto production in the RFE. He reported the company had invested \$60 million on infrastructure to get the auto assembly plant working (Zagorodnov, 2012). As for foreign investment, Korneychuk stated that, “the barriers to doing business would probably offset any labor costs” (Zagorodnov, 2012). Of 2200 luxury vehicles produced by *Sollers* in the RFE in 2009 over 1800 were shipped to European Russia (Kalachinsky, 2010, pp. 6). This does little to utilize comparative advantage (in this case proximity to local and Asia-Pacific markets) and by offering subsidies for auto production in the region, Moscow is encouraging distorted economic inefficiencies.

International trade and transport have been championed by the Russian Federation as a great potential growth point for the RFE. Despite its strategic location, the Far Eastern ports endure severe climates and it is expensive to go through customs and to use the Russian railway system. In 2010, 62% of Primorsky Krai's imports were from China, suggesting a higher reliance on Chinese processed materials than is reciprocated by the boom and bust nature of natural

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<sup>12</sup> Based on author's personal experiences in Vladivostok it is commonly known that used cars are sawed in half to be imported as parts from Japan, then reconstructed for sale on the Russian side. For further discussion of the current state of the used automobile market, please see Armbruster (2009, May 12).

resource demands in the Asia Pacific countries. The exception is the demand for energy, but the highly centralized nature of the Russian energy sector suggests that profits from this sector will enrich a small portion of centrally located Russian elites.

It is within this economic structure that the Russian Federation has developed and begun to implement a new reform strategy, the *Federal Strategy 2025*, to address continued social and economic difficulties in the RFE region. As discussed above, the comparative advantages in the RFE currently lie in capital-intensive industries – oil and mineral extraction - that offer limited possibilities of top down growth to the region. It would thusly be imperative that a government development strategy address the paucity of employment opportunities available locally and attempt to increase welfare of the region by holding resource extraction industries accountable to offset environmentally destructive aspects of their operation.

In order to assess the potential for future growth in Primorsky Krai, and for Vladivostok in particular, it is instructive to set realistic expectations for sustainable economic growth for a port city in a difficult climate such as Vladivostok. Similar geographic conditions can be found in the northerly port cities of Halifax, Nova Scotia and Anchorage, Alaska.<sup>13</sup> Anchorage makes up for its high cost of living (compared to the contiguous United States) by offering higher wages to its residents and a bundle of economic incentives: no property tax, no sales or use tax on businesses, corporations are taxed only on a portion of their net taxable incomes, etc. (Anchorage Economic Development Corporation, 2010). The average income in Halifax is also adjusted up to account for higher costs of living, about 10% higher than the Canadian average (Greater Halifax Partnership, 2012). The population of both Halifax and Anchorage are lower

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<sup>13</sup> 43°08'N 131°54'E are the coordinates of Vladivostok, 61°13'05"N 149°53'33"W are the coordinates for Anchorage, and 44°51'16"N 63°11'57"W are the coordinates of Halifax; all three port cities have similar geographic coordinates.

than Vladivostok (296,400 and 400,000 respectively). Both cities are currently demonstrating economic growth, largely due to their ability to capitalize on their comparative advantage, creating centers of specialization in marine and biological sciences and letting their natural resource wealth trickle down to the population.

Learning from these cities, the government of Russia may want to consider allowing Vladivostok to support a smaller population and abandon the non-economically motivated immigration policies similar to those employed during the Soviet period. By building upon areas of comparative advantage, such as the clusters of marine research and related industries, Primorye could use its remote geographic locations to generate enough wealth and local employment opportunities to justify reliance on imports and high transportation input costs. The next chapter will explore the current government program for growth and development of Primorsky Krai. The potential for the long-term success of proposed investments will be analyzed and the methods of implementation will be considered in light of what these developments may tell us about the future success of current projects.

### Chapter 3: The Current Federal Reform Program

Russian reformers who helped shape the Russian economy during transition focused on depoliticizing economic structures. The fate of reform in the RFE was varied, but extended periods of uncertainty mitigated the intended effects of price controls and privatization. The uncertain climate constrained positive effects of relaxing rules for small business. Putin introduced political recentralization in order to strengthen Russian leadership. Although the stated goals of economic reform remained the same, in practice economics shifted towards centralization. Moreover, the federal government assumed ownership of natural resources and introduced tax structures funneling profits back to Moscow. The *Federal Strategy 2025* varies from previous reform programs because the promised investments are currently underway. However, the planned investments have inherent limitations and threaten to reunite the political control of the economy that was the very basis of the original Russian reform program. By reestablishing political control of economic decisions, one would expect to observe institutional corruption and inefficient allocations of resources. Thusly, the end result of the investments may be no net overall change in the RFE as the underlying economic difficulties are not addressed. This chapter applies this framework to describe how Russian investments in Primorsky Krai to prepare for the APEC 2012 Summit reflect how the ideals of the *Federal Strategy 2025* are distorted in implementation. Please refer to Table 1 at the end of the paper for a summary of the action plan of the *Federal Strategy 2025*, the measures underway or already completed, and their predicted results.

Boycko, Schleifer and Vishny, the reformers who designed the nationwide privatization program in Russia during the early 90s, described “depoliticization of economic life as the principal benefit of privatization” (1995, pp. 1). In fact, this separation was not only the goal of

privatization, but of successful reform from the command system in general. Economic decisions made by politicians would by nature be first filtered through political and social considerations. Giving politicians control rights to resources separate from cash flow rights creates agency problems due to politicians' incentives to pursue personal enrichment over value maximizing options. Achieving economic efficiency and maximizing societal welfare are then secondary to satisfying the personal gain of the politician. Uniting cash flow and control rights of assets to private parties outside of political control was the major goal of Russian privatization. Reformers also noted the need to shift to raising profit-motivated investment instead of reliance on politically motivated investment from government sources (Boycko et al., 1995). Promoting competition among firms and removing barriers to market entry would create incentives for business owners to reinvest into the future of their firm rather than focus on short-term profit gains.

Complete privatization and the establishment of competitive markets have yet to be achieved in the RFE. The *Federal Strategy 2025* is the outline to correct economic inefficiencies at the local level, but this program emphasizes the reestablishment of many of the structures that the original reforms sought to avoid. By reasserting the control to plan economic development, subsidizing the desired growth, and establishing federal positions to monitor and report on the progress of the investments, the Russian Federation is closely approximating the economic models and roles of the Soviet Central Planner. As such, we would expect the same corruption and cronyism to emerge when transferring large sums of government money to fund local development projects.

The implementation strategy of the *Federal Strategy 2025* provides insight into the contemporary business climate and economic structure of the RFE. Central control of

investments, the allocation of state contracts, and the points where future profit flows will accumulate all indicate that the administrative rules continue to create incentives and opportunities for personal enrichment over achieving economic efficiency. As financial investment has not been matched by legislative reform, the legal basis needed to create a stable and welcoming investment climate continues to lag. A comparison of the stated reform goals of the *Federal Strategy 2025* and the actual structure of implemented investments indicates that few true reforms have yet to result from the program and the current economic climate mirrors the difficulties described by Boycko, Schleifer and Vishny at the end of the Soviet period.

The *Federal Strategy 2025* asserts that economic activity must be under government jurisdiction in direct contradiction of Boycko, Schleifer and Vishny. Solutions to economic difficulties should be pursued through fixed mechanisms of law to support growth, central government investment, and increased migration into the region (*Stratigiia*, 2010). In context of the federal plan, this means increased central supervision and control of social and economic development – the two main foci of the reform program. The program focuses on recentralization and political control of the economy, leaving control rights to politicians and cash flow rights to the general populace.

The *Federal Strategy 2025* identifies the main weakness of the regional economy as overreliance on raw exports of natural resources: of exports from Primorsky Krai 30.4% are raw materials for production, 19.3% are metals and metal products, 21.3% are logs and products for timber processing (2010, pp. 3). According to these data unprocessed goods total 75.7% of exports, signifying a substantial loss of potential for value-added services on the Russian side. The program prescribes large-scale investment projects to modernize infrastructure to diversify the economic base of the region. By creating the capacity to process high volumes of cargo

transport and establishing processing centers nearby, Primorsky Krai could establish itself as a logistics management hub, a major transit point for trade, and as an energy exporter to the nearby Asia-Pacific economies. Improved infrastructure and management training would also create a booming tourism industry to the region. Logistics management, tourism, and improved resource processing abilities could increase the share of profit captured domestically.

Stronger oversight and clarity in local legislation could allow legal markets to compete with illegal trade, widen possibilities to work with foreign financial institutions, and create the potential for strong Russian international corporations (*Stratigiia*, 2010). The *Federal Strategy 2025* indicates the need to attract foreign capital to realize the full scope of suggested investments and the need to create a positive investment environment to achieve this end. The program suggests strengthening central administration and improving the quality of local government to attract foreign investment. The program does not get more specific than stating this will be done by codifying laws governing investment giving “preference to projects that support the reform program” (*Stratigiia*, 2010, 44).<sup>14</sup> The nature of government approval over new investment projects remains undefined in scope, perhaps to leave the door open for future government intervention, as has been the case in the energy sector.

The second goal of the federal reform program is to improve living conditions and create a stable population base in the region. The program identifies the need to increase access to social services and education, to improve the small business climate, and to attract migrants (*Stratigiia*, 2010). The region must generate and attract workers with sufficient technical and management skills to support new areas of specialization (such as logistics management,

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<sup>14</sup> The document specifically states that regulation of investment should be monitored to support desired base industries; this expansion of what will in all likelihood be central control is reminiscent of government reforms to fully control investment into natural resource industries.

tourism, and energy). The establishment of the Far East Federal University (FEFU) is proposed as a partial solution; educational resources will be expanded in hopes of creating a prestigious modern university with the ability to attract talented youth domestically and internationally who will become permanent residents and participants in the economic development of the region.

Increased access to social services is identified as a need in the region, but steps the federal and local governments will take to increase funding for social support programs are not specified. The strategy further recognizes the need to reduce wage differentials and reduce unemployment, but intermediate steps to assist those currently struggling are left undefined. Increased educational opportunities and promised investment into health care and cultural facilities have the potential to contribute to future population stability of the region, but the reform program does not address immediate steps to engage unemployed residents of the RFE and slow current outmigration.

The *Federal Strategy 2025* assumes that investment in the modernization of industry, infrastructure and educational facilities will improve the current business climate. The program does not offer a strategy for social and legal reforms needed to create accountable institutions and can thusly be understood more as an investment outline than a reform program. Legal reforms (lowering tariffs to increase international trade, increasing transparency and accountability in local government, improving access to and widening social safety networks) and, most importantly, ending the political control of economic developments are prerequisite steps to creating a well-functioning free market economy in the RFE. By neglecting these initial reforms, corrupt government, inefficient management, perverse economic incentives for workers and managers, and a questionable investment climate will continue to be underlying difficulties threatening the future of current central investments to the region. As Boycko, Schleifer and

Vishny state "...when firms are subject to political influence they cater to politicians" resulting in "grossly inefficient practices" (1995, pp. 11). Such results were typical of large-scale Soviet investment projects, and these behaviors can be observed throughout the implementation and planning process of current investments in Primorsky Krai.

Additionally, the program does nothing to curb overreliance on central subsidies, a major difficulty of the transition period. Without addressing necessary reforms to foster a healthy business climate, it should not be assumed that building modern infrastructure and new educational facilities will be able to generate profits in future periods. As profits from the energy sector can realistically be expected to be transferred primarily to the center, little is being done to increase the amount of revenue that will remain in the region. The significance of the failure to preemptively follow through with administrative, legislative and judicial reforms is exemplified by the manner in which the investment projects are being handled by local industries and political elites.

Russia originally bid to host the 2012 APEC Conference in 2006.<sup>15</sup> Minister of Economic Growth and Trade, German Gref assessed the possibility of hosting the event in Vladivostok during a visit to the city in 2006.<sup>16</sup> Upon return to Moscow, Gref expressed indignation over the request for 382 billion rubles to finance not only construction of buildings for the conference (originally intended to occur on Patrokl Bay, with Russkiy Island a lesser preferred variant) but also water supply and cleaning facilities, bridges, roads and other items needed in the city that did not directly relate to the APEC Conference. Gref concluded that the city's problems were not

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<sup>15</sup> The APEC Conference is an annual meeting, member countries put in bids to host the conference. Please see Appendix A for a more in depth discussion of the APEC organization and Russia's involvement in it.

<sup>16</sup> Gref is the reformer responsible for streamlining the tax regulation system in the early 2000s and deregulating the business climate. Refer to Aslund, 2007 for an explicit discussion of Gref's role in reform under the Putin administration.

Moscow's responsibility and that local officials had demonstrated "extreme unprofessionalism" with their exorbitant requests ("*Moshennik zarabotal*", 2006).

Vladivostok was selected nonetheless, but Gref's remarks indicated remaining tensions between federal and local officials. Darkin announced the commitment of the federal government to the project and to 147.5 billion rubles of investment in 2007, a figure that kept increasing as time went on. The planned projects were the construction of the meeting complex on Russkiy Island (later to be converted into the new FEFU campus); the creation of necessary infrastructure (roads, sewage, electricity, etc.) to service Russkiy Island and improve existing systems in Vladivostok; the construction of bridges across Golden Horn Bay and to Russkiy Island; the building of a hospital, theater, and conference center; and renovations to the façade of historic Vladivostok. Gasification remained a major goal, now designated to *Gazprom* controlled joint venture projects.<sup>17</sup> Darkin optimistically predicted the "gross regional product would expand to over six times its current size by 2020" ("*Gubernator Primor'ia*," 2007).

Moscow had agreed to bankroll developments to improve the general quality of life in the city, but as federal funds were transferred, suspicion over their appropriate use was quickly transmitted to the center. Although Moscow has sought to increase central presence in the region, there are limits on the ability of the center to accurately collect all necessary information from the regions that inevitably lead to distortions in economic decisions (Stiglitz, 1994). The sudden influx of what is now to total 426 billion rubles, or about 60 times the usual budget of Vladivostok, created myriad opportunities for cronyism, kickbacks, and rent seeking (Kalachinsky, 2010). This unprecedented level of support, after years of failed promises from the

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<sup>17</sup> See Bradshaw, 2005 for more information. His article on Sakhalin discusses why Russia continues to be reliant on foreign investment and expertise to develop its oil and gas projects. He also addresses the tendency of Russian managers involved in these projects to discuss large future investment projects as if they did not rely on foreign funds.

center, threatened to create incentives to maximize available payouts while possible before entering a new period of economic stagnation. Perceptions of the investments as a one-time opportunity are bolstered by the history of failed promises and the context of looming austerity measures should European financial markets cause the Russian market to again decline.<sup>18</sup> Russia has been insistent on continuing with the investments despite the uncertain international economic climate, but this does not bode well for future federal support.

Residents of Primorsky Krai have a widely held belief that federal funds are not entirely spent on intended purposes.<sup>19</sup> Governor Darkin excluded local businesses from participating in auctions for lucrative APEC construction contracts – auctions that either did not occur at all or went ahead when only one bidder remained (Kalachinsky, 2010). Foreign firms chose not to bid on construction projects, considering the timelines too inflexible and unrealistic. The opportunity to learn from foreign expertise and management capabilities and build working relationships within the Asia-Pacific region was lost. The attempts to construct large scale engineering feats, such as the bridge to Russkiy Island, under short time constraints have already led to “storming” techniques used to meet quotas in the Soviet period.<sup>20</sup> Construction on the bridge operated on a 24 hour a day schedule.

Contracted firms have low-paid immigrant workers carrying out the projects rather than employing local jobless Russians (Sulimina, 2011). Responsibility is diffuse. The Moscow-based

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<sup>18</sup> Prior to the 2008 financial crisis Russia believed its economy had decoupled from economic shocks in western economies; now after experiencing difficult effects of the 2008 crisis Russians have increased apprehension over the future of the international economy.

<sup>19</sup> This is based on the author’s personal experience speaking with a wide variety of citizens in Vladivostok over the summer of 2011 and is evident in scholarly articles from the region. Refer to Kalachinsky and Sulimina for explicit reference to misuse of federal funds.

<sup>20</sup> Storming refers to brief period of intense work done to meet production quota in a short timeframe under conditions where worker productivity is typically low. In Soviet times storming was a normal occurrence in factories approaching quota deadlines and frequently had a negative impact on quality of finished product.

Crocus Group, responsible for the construction of FEFU, has contracted construction to local firms; although Crocus Group acknowledges the failure of wages to be paid on time to local workers, they do not assume responsibility for this and it does not affect their contracted payments (“Uzbeks,” 2011).<sup>21</sup> Crocus Group owner Aras Agalarov explained in an interview that to find the necessary 10,000 workers, “there were not enough local construction workers and so the majority of workers were invited from CIS countries” (Popova, 2012). In the same interview Agalarov goes on to admit that the region was incapable of supporting such a large construction project and the majority of supplies were also imported, this time from Western Russia (Popova, 2012). The manner in which these construction projects are being realized fails not only to satisfy the goal of the *Federal Strategy 2025* to address local employment issues, but also fails to meet the stated aims of decreasing waste and inefficiency in industry, improving the conditions and security of work, and increasing average wages (2010, pp. 34-35).

In 2008 Sergei Stepashin, Head of the Account Chamber of the Russian Federation, traveled to Primorsky Krai to audit the projects underway. He found that although many projects would be completed on schedule only 6 of 36 projects underway had properly documented their expenses. Stepashin publicly emphasized the necessity of “removing the ‘criminal’ label from Primorsky Krai, otherwise serious investment would be impossible” (“*Predsedatel’ Schetnoi*,” 2008). No further actions were taken at the time and central funds continued to pour in. Another federal checkup was conducted in 2011 to address concerns about the project management of Vladivostok Mayor, Igor Pushkarev. Specifically of concern was the ratio of funds transferred to the region to the amount of work completed.<sup>22</sup> Airport renovations, for example, had received

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<sup>21</sup> Local contracted firms include the firm Pragma, SKMost and Mostovik.

<sup>22</sup> Public speculation on whether Pushkarev has appropriated funds was heightened by his entry into *Finance* magazine’s list of the youngest ruble billionaires in Russia. His previous entry in 2006 estimated at 25 million USD

about 65% of their allotted funds but renovations were only about 30% completed (Aleksandrov, 2011). No documentation existed for the use of the missing funds. Similarly unclear was the fate of 2.5 billion rubles transferred for the renovation of the historic façade of Vladivostok - of 913 buildings marked for repair, as of 2011 only five were being worked on (Aleksandrov, 2011). Again no actions were taken against local officials and President Medvedev has repeatedly expressed approval of the progress on preparations for the conference.

The selection of *Tikhookeanskaya Moststroitel'naya Kompaniya* (TMK) as the contracted company to construct the bridge across Zolotoy Rog is a first example of how political considerations affect the implementation of economic reforms. Although several firms were originally involved in the auction, and the St. Petersburg Company, *Giprostoimost*, was already publishing its expected victory, by the time of the auction TMK was the only company putting in an offer. The exit of all other firms from the auction is suspicious in light of the fact that all previous TMK projects are somehow connected to former Primorsky Krai governor Sergei Darkin (Armbruster, 2008, Jun. 30). Another example of political influence is the selection of *SpasskCement* as the primary provider of cement for APEC construction projects. Mayor Pushkarev began his career in *VostokCement*, the parent company of *SpasskCement*. Today Pushkarev's younger brother owns a 90% stake in this parent company. In a leaked diplomatic cable a U.S. official described *SpasskCement* as insolvent – unable to meet production targets and provide minimal health and safety precautions to its employees - and commented that it was likely to remain so despite receiving past government subsidies and the lucrative APEC contract (Miller, 2009). Further, the diplomat predicted that living standards in the region were unlikely

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indicates that his net worth has increased over fivefold in five years, while he has been holding various government posts.

to be affected by increased production at the factory (Miller, 2009). The predicted trickle-down effect, an assumed benefit of the federal plan, has failed to materialize.

Residents of Vladivostok not directly engaged in the construction projects have also felt negative effects of new developments. The construction of the bridges required the displacement of those living in areas that would be demolished for the project. A retired army officer, Gennady Paskotin, showed his new “townhouse” to a local reporter, displaying the “plasterboard interior walls and crooked alignment” (Mayr, Neef & Schepp, 2012). The quality of replacement housing offered to displaced residents has not been widely discussed as the focus is on the luxury accommodations being built to house the foreign dignitaries.

Even seemingly non-political investments are highly politicized. The central investment project for the APEC Conference is the transformation of Russkiy Island from an undeveloped military relic to a booming university town. Federal universities are part of the federal educational reform program to normalize educational standards across Russia. In Moscow and St. Petersburg federal universities have attained a high level of funding, recognition and prestige. In the RFE, the name of the Far Eastern State University (FESU) was simply changed to FEFU. FESU staff expecting to receive increased pay and prestige instead inherited an unwanted commute to Russkiy Island.<sup>23</sup> Politics complicated the appointment of a rector for the newly established university as well. Moscow hoped to establish legitimacy and prestige of the institution by appointing a member of the Academy of Sciences, but was unable to find a candidate willing to relinquish their post and move to the undesirable RFE. The appointment of the former FESU president was impossible as his promotion threatened to upset the center-

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<sup>23</sup> In conversations with the author, professors from the Vladivostok State University of Economics and Service expressed relief that their institution had somehow escaped integration with the new FEFU; although they also complained of low salaries, these professors were relieved not to be dependent on the Russkiy Island experiment.

periphery balance of power.<sup>24</sup> Eventually a mutually agreed upon candidate was appointed, Vladimir Miklushevksy, who assumed the responsibility of Primorsky Krai Governor when Darkin was dismissed in February 2012. These actions highlight tensions in center-periphery relations and the extreme level of political involvement in education in the region.

Struggles between regional and federal government officials continue to slow reform and stymie the *Federal Strategy 2025*'s goal to “coordinate the actions of government officials in the krai, local self governing organizations, leaders of agriculture, entrepreneurs, social organizations, and citizens of the krai to unite towards achieving the program goals” (2010, pp. 1). Political struggles have complicated the basic processes of selecting the site of the summit, setting the scope of investments, and dispersing federal funds. Federal audits serve as a federal control mechanism, but nonetheless Darkin and Pushkarev were directly involved in the implementation of the investments and appear to have personally profited from these control rights. Misappropriation of funds is widely recognized and local citizens display complacency towards this. Resultantly, politicians risk little reputation loss by engaging in self-enriching behaviors.

According to Boycko, Schleifer and Vishny one would expect to observe institutionalized corruption and inefficient economic allocations in a system where political actors have control over economic decisions. Political actors seem to be exercising such control, and the implementation of development projects do not suggest economic efficiency is being achieved. It would be reasonable to expect the outcome of the current investment projects not to differ greatly from investment projects carried out in the past under similar socialist structures. Please

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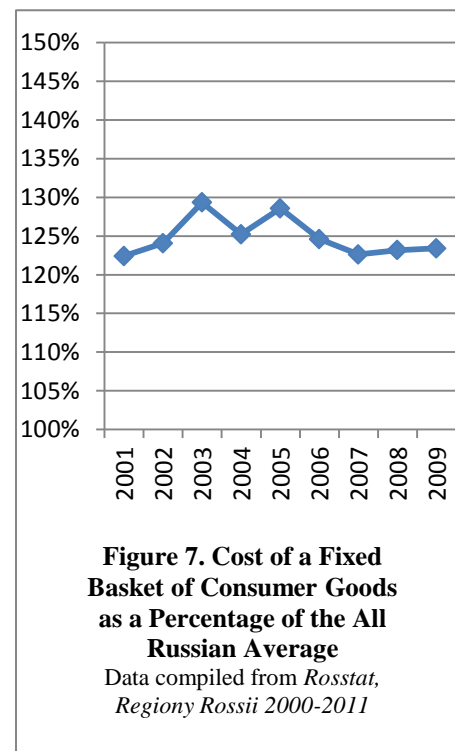
<sup>24</sup> Specifically, Governor Darkin refused his appointment as Moscow had attempted to oust him in the past in favor of Kurilov (not in relation to activities associated with the current investment projects). See Kalachinsky for a more detailed description.

refer to Table 2 at the end of the paper for a list of the current joint stock companies in Primorsky Krai and their ownership structure; this reveals that although foreign investment is a large focus of development in the region, most of these investment projects are majority owned by the regional or federal governments with little active foreign investment into private joint stock companies. The next chapter will use current demographic and economic indicators to assess how well specific projects are achieving their corresponding goals.

## Chapter 4: Economic Indicators in Primorsky Krai

Economic data suggest that in the short term many projects have failed to meet the corresponding aims laid out by the *Federal Strategy 2025*. This is an expected result considering the lack of market supporting infrastructure in the region discussed in the previous section. Nonetheless, the current projects threaten to create an additional burden on the local economy if they are unable to generate revenue to support their own future maintenance. Short-term economic indicators suggest that in the present period the inflow of money to Primorsky Krai has not generated increased quality of living, population stability, or attraction of foreign capital. Investment projects do not alter the underlying economic structure and do not influence the incentives of people living in the region towards stewardship of local resources or reinvestment in local business. To the contrary, the investments have created more short-term opportunities to engage in rent seeking and large contracts have not gone to local businesses.

Investment of modern infrastructure could potentially create opportunities to build global competitiveness, but alone investment into selective modernization does not address the primary underlying causes of poverty and difficult living standards, nor does it allow for the creation of a stable long-term social safety net. Examining the cost of a fixed basket of consumer goods and services in Primorsky Krai reveals that prices remain around 123% of the all-Russian average (see Figure 7).



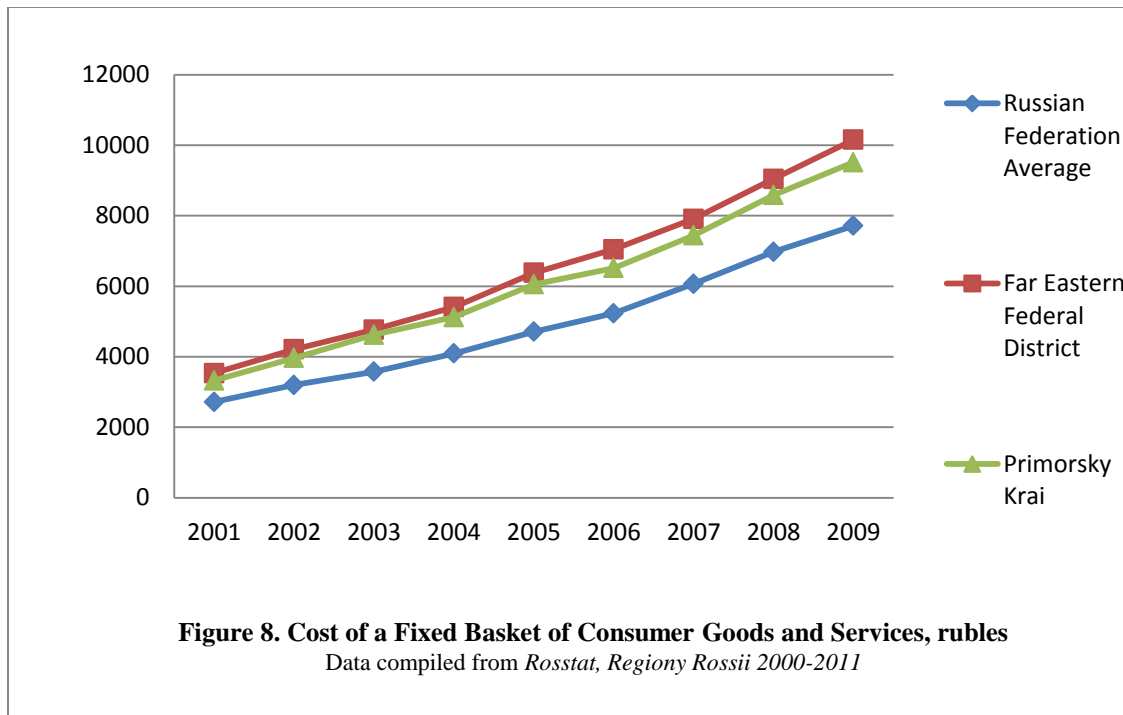
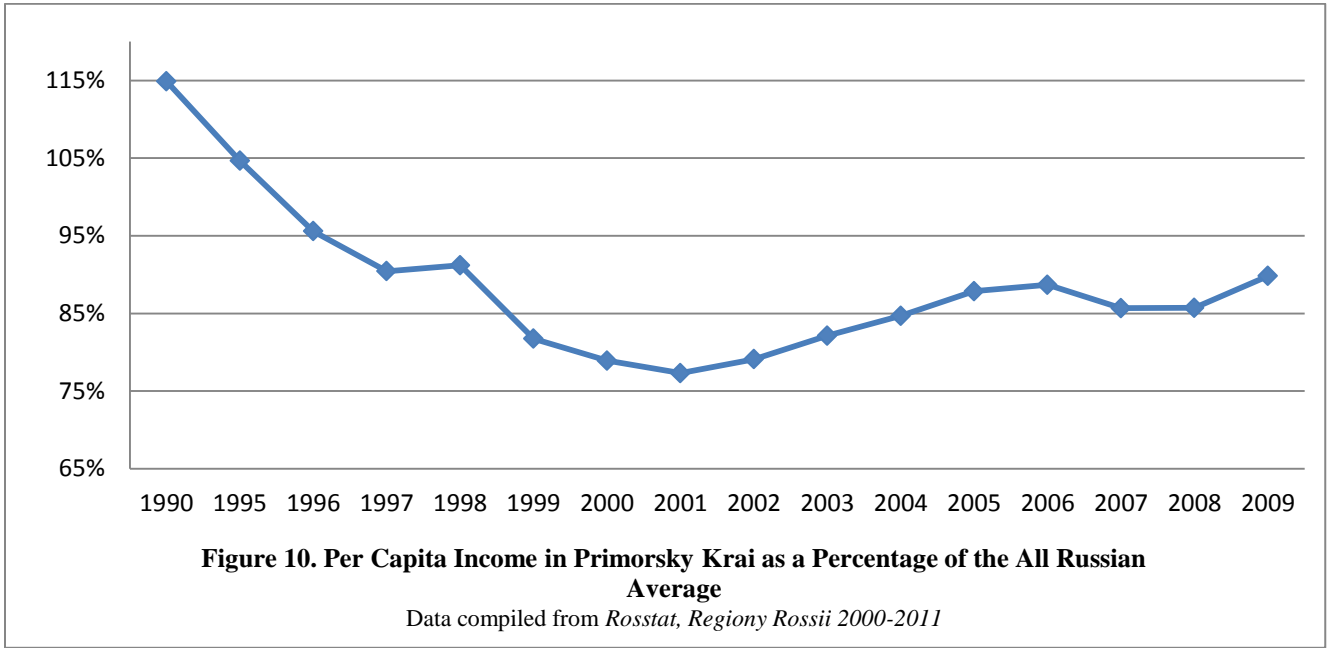
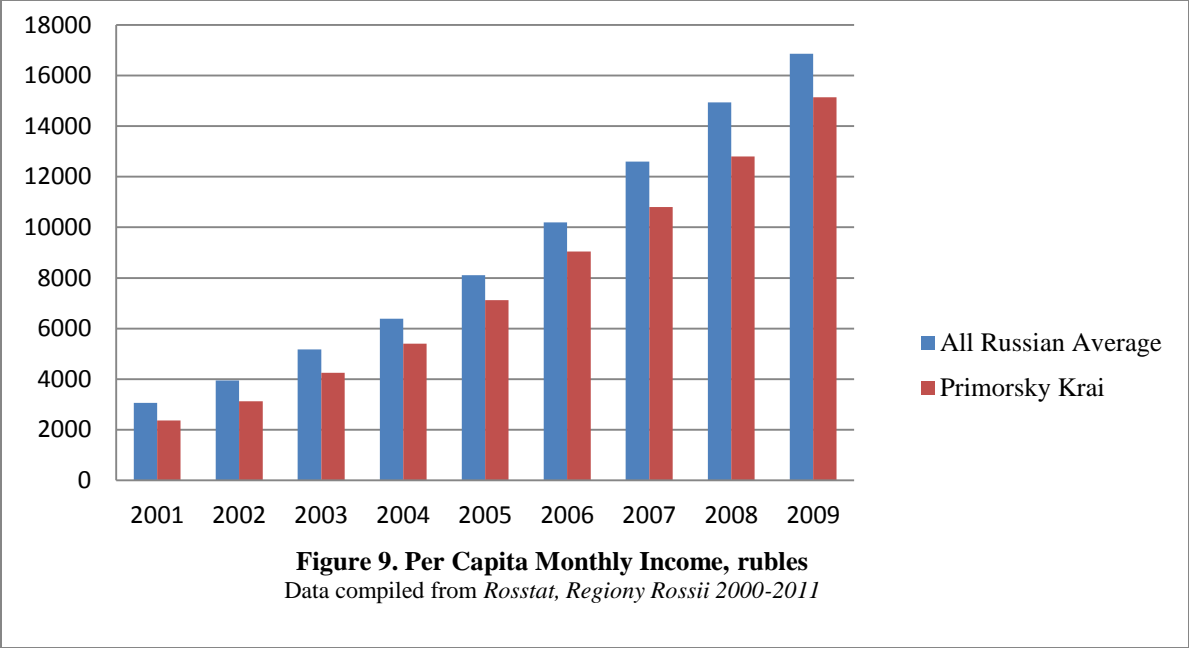
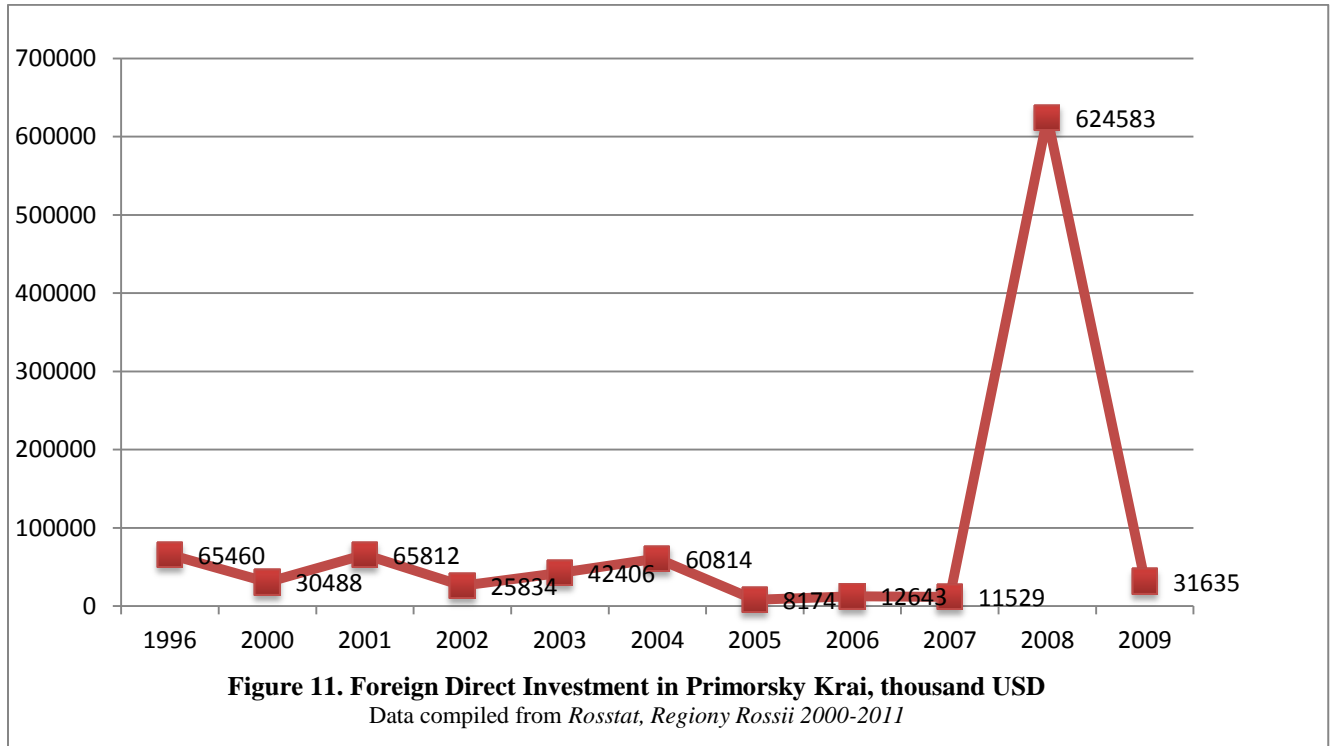


Figure 8, above, illustrates that prices in Primorsky Krai and the Russian Far Eastern Federal region both continue to grow above and apart from the all Russian average. At the same time, as shown in Figures 9 and 10 (below), the per capita income in Primorsky Krai remains lower than the all-Russian average and the difference is growing. With higher prices and lower wages, government subsidies are the only way to raise living standards in the region up to all-Russian averages. The subsidies of the present period are, however, not intended to be permanent. The *Federal Strategy 2025* proposes to solve this regional poverty in the long term by attracting foreign investment to the modernizing region.



In theory, this is a necessary step. Boycko, Schleifer and Vichny assert that attracting real, direct investment rather than relying on government subsidies is necessary for sustained, real growth (1994). The *Federal Strategy 2025* predicts that government investment and reform

would attract a significant amount of foreign direct investment (FDI) to the region. Figure 11 shows the annual foreign direct investment to Primorsky Krai in United States dollars (USD).



Aside from a sharp peak in investment during 2008 (a more detailed breakdown of investment by sector available from *Rosstat* – the official Russian statistical service – indicates that this was in the transportation sector), the amount of FDI has remained uniformly low. An examination of past investment patterns by sector as well as the current prospective investment projects in Primorsky Krai shows that the main recipient of foreign investment is the energy sector – not the investment into processing and value-added services the region would need to experience diversified production and employment. The energy sector itself is heavily reliant on foreign capital and expertise, and will continue to be until Russia can produce its own technical experts. Despite the potential for growth in this sector, the players involved, primarily *Transneft* and *Gazprom*, are state-owned companies that funnel their profits back to Moscow.

Although some firms have received substantial foreign aid, they face challenges to becoming profitable enterprises. For example, the Far East Shipping Company (FESCO), which was successfully privatized during the 1990s, has received a \$135 million loan from the European Bank for Reconstruction and Development (EBRD) to help fund modernization and increased capacity at its far eastern port in Vladivostok. FESCO is unique in that it is vertically integrated – it owns its own facilities up the logistics chain such that it can handle trans-Russian shipments independently of cooperation with other private or state owned companies. FESCO's container traffic through ports increased by 34% in 2011, but the company was still running at a loss of \$19 million during the year (Bonar, 2010). Although FESCO has benefitted from contracts to transport building materials to Russkiy Island during the pre-summit construction phase and has been granted a large loan from the EBRD, it has been unable as of yet to be profitable. The reason that FESCO continues to do poorly even with outside support is similar to the reasons that the joint-stock venture VICS struggled in the 90s. It is difficult to operate efficiently in a vacuum with poor infrastructure and management from every intermediary. Unless the efficient company can afford to correct all surrounding infrastructure, the poor surrounding economic climate will be a severe limiting factor for growth.<sup>25</sup>

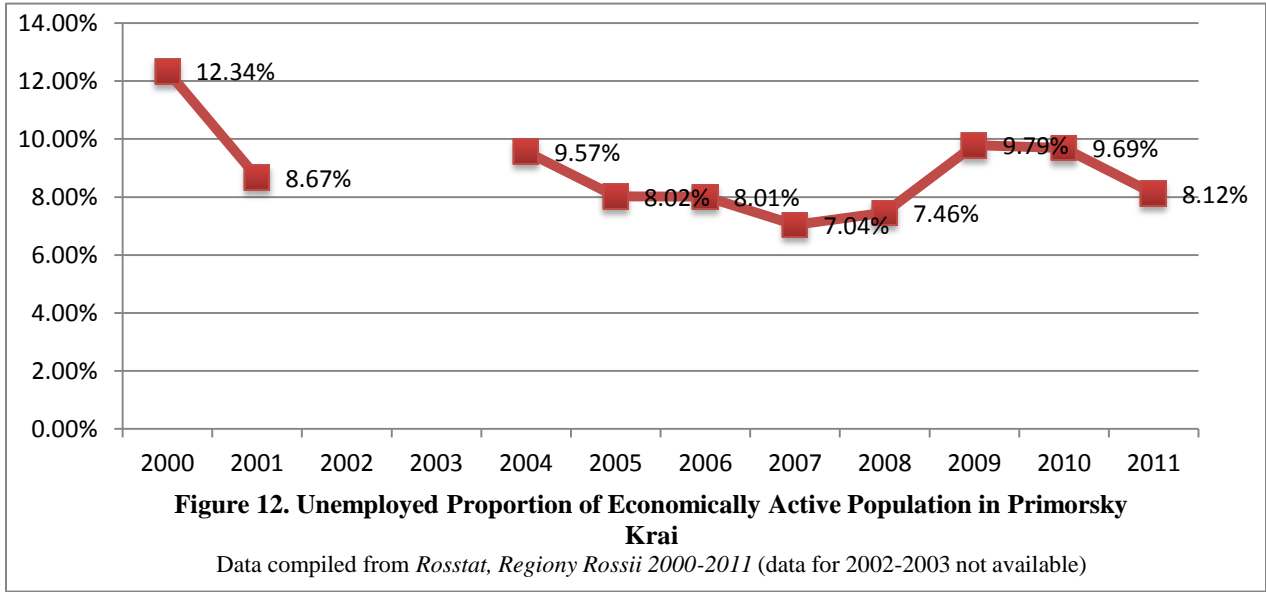
The *Federal Strategy 2025* identifies the gasification of the region and an emergent role as an energy exporter as one of the main goals. However, the energy sector is capital, rather than labor, intensive, and will create few jobs for local residents. Low wage construction jobs have tended to go to migrant workers, while foreigners also occupy the highly skilled leadership positions due to the lack of adequately trained human capital. Leadership positions in the energy industry will be limited to foreign experts for the foreseeable future. Bradshaw (2006) described

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<sup>25</sup> See Mikheeva and Thornton, 1996 for a more in depth discussion of the VICS case.

how at industry meetings Gazprom officials in the RFE would habitually outline grandiose development projects without mention of how they would be financed or implemented. This attitude, paired with the failure to create a stable investment climate, will remain limiting factors on new joint venture projects.

The federal government intended for the construction projects in Primorsky Krai to address unemployment problems in the region and, if not from energy, these jobs would be created in other sectors. Figure 12, below, shows the unemployed proportion of the economically active population of Primorsky Krai. From 2005-2011 the unemployed proportion has hovered around 8% with little change. These data, compiled from the local statistical reporting service *Primstat* defines the “unemployed” population as those who are actively seeking work, but have been unable to find employment. As such, the true “unemployed” proportion – including those who have given up looking for jobs or were never trying to find them, is likely much higher. One would expect to see a decline in job seekers around 2006-2008 when the construction on the bridges and FEFU began – as they employ 20,000 workers at any given time, but this is not reflected in employment data.



Construction for the APEC Conference did fulfill the promise of creating new jobs. The FEFU complex alone required 100 contractors and 20,000 workers on the site (“Uzbeks,” 2011). According to one estimate, the number of migrant workers in Primorsky Krai has risen from 1999-2009 from 10,300 workers to 30,900, tripling the level of migrant workers. As of 2008, most migrant workers in the RFE were located in Primorsky Krai (Iashakova, 2009).<sup>26</sup> Aras Agalarov, owner of the Crocus Group, admitted that it was necessary to import the majority of the workers because there simply were not enough willing and available in Primorsky Krai (Popova, 2012). There have been numerous reports of disturbances related to the low income and poor treatment of migrant workers, who are housed in dormitory style temporary barracks set up near to construction sites.<sup>27</sup> These working conditions do not foster the necessary environment to create a stable population base, nor do they foster incentives to perform a high standard of work or pursue a long-term career or specialty in construction. Lastly, poor treatment of workers fails to meet the *Federal Strategy 2025*’s goals of creating a safe and accountable working place.

As of early 2011 the trade balance of Primorsky Krai continued to be skewed towards reliance on imports. In the first quarter of 2011 the Krai imported 1261.3 million USD worth of goods, while exporting only 465.2 million USD worth of goods. This puts their trade balance at a -796.1 million USD (*Federal’naia Tamozhennaia*, 2012). Shifting this balance is a major goal of the *Federal Strategy 2025*, which aims to capture the value added services on the Russian side. At the present time, if federal transfers decline, the region will have difficulties building

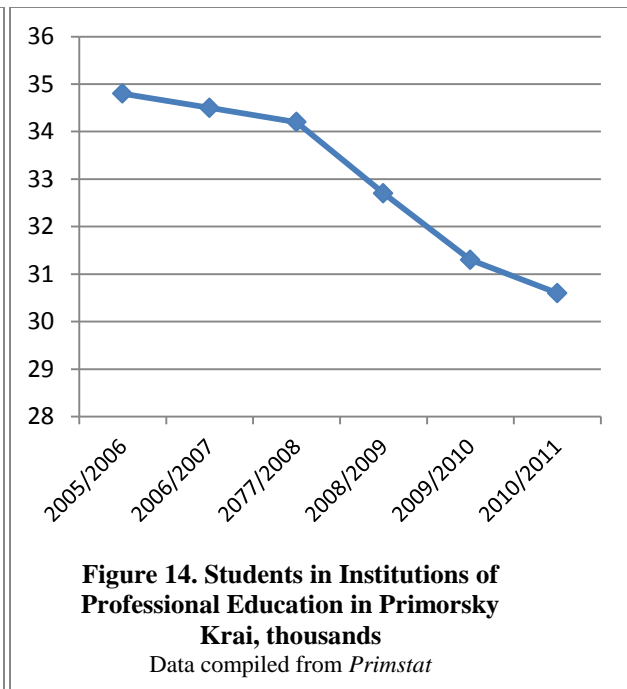
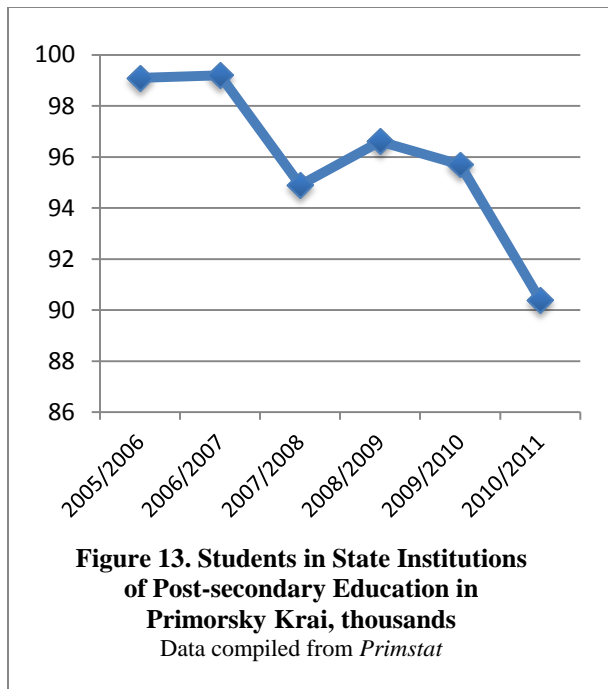
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<sup>26</sup> It should be noted that the RFE does not have a disproportionately high presence of foreign workers in context of the Russian Federation as a whole. As of 2008, only 3.7% of migrant workers in the Russian Federation were located in the RFE; however, Primorsky Krai claims 33% of all migrant workers in the RFE, giving it a disproportionate

<sup>27</sup> In the author’s personal experience, a professional colleague related a story of 10-15 central Asian workers living in the one bedroom apartment next to hers – she complained that their activities would often spill into the hall and commented that when passing by she noticed they had little or no furniture.

processing industries to capture more of the value added, and balance the trade deficit, independently.

The centerpiece of the investments to Primorsky Krai, the construction of FEFU on Russkiy Island, may prove to be more of a financial drain than financial driver. The dwindling size of the potential student base in Primorsky Krai suggests that this giant and remote educational institution will continue to rely on government subsidies rather than on tuition payments. Figures 13 and 14, below, illustrate the decline in students of post-secondary education in Primorsky Krai up to the present time. In the face of declining demand, the creation of a gigantic educational institution appears similar to misguided attempts of Soviet central planning to generate supply without knowledge, access or reference to realistic estimates of demand. The goal of the high tech university is to create locally the highly skilled experts needed to run the energy, logistic, and tourist regional specialties in the future. Unfortunately, there is no indication that the university will have access to a willing pool of students, nor is there any indication that these sectors will emerge so long as living standards remain low and people are forced to focus on day to day survival.

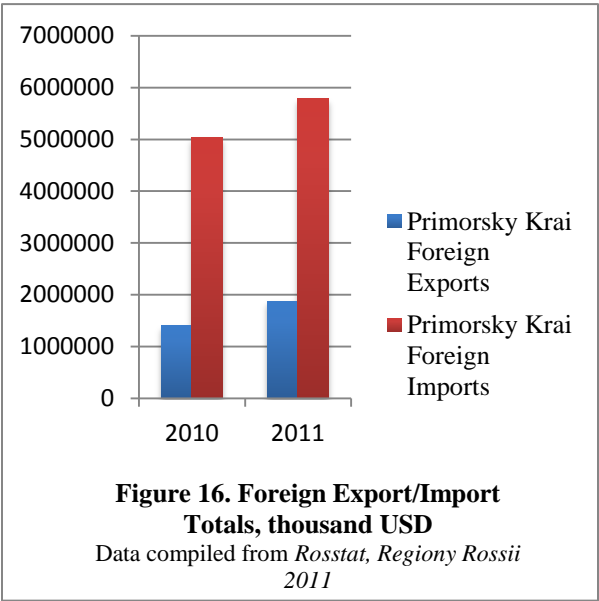
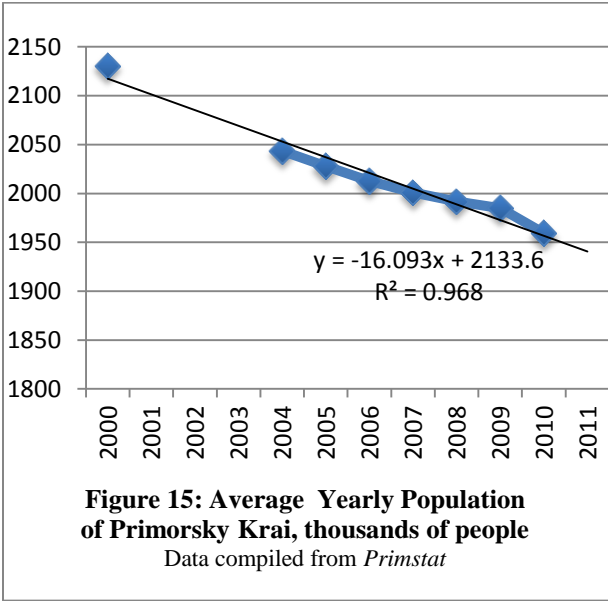


According to Vadim Zausaev, the Director of the Far Eastern Market Research Institute, a 2008 survey found that 70% of those living in the RFE would leave *immediately* if a better economic possibility arose (Armbruster, Sep. 2008). FEFU will have the capacity for 50,000 students, which is nearly the entire population of students scattered throughout the current educational options in Vladivostok. Currently the main attraction of foreign students to the city is price and the ability to learn Russian language; the university would have to quickly establish a phenomenal educational reputation in order to support a huge future influx of foreign students. Producing qualified professionals who desire to remain in the region is a further difficulty. Current Vladivostok residents find the location of the university on Russkiy Island as remote. Aleksandr Latkin, a leading professor of economics in Vladivostok commented that he would not accept an offer to work at the university and would not recommend others to send their children there due to the remote location and extreme weather conditions (Armbruster, Sep. 2008).

As budgets for projects in Primorsky Krai are overrun, some social services have been eliminated from the plan. The proposed hospital facility has been withdrawn and the plan to build a presidential residence in Vladivostok has been canceled. According to the press secretary of the Office for Presidential Affairs of the Russian Federation the state residence was proposed, but canceled for “financial reasons and for a reordering of priorities of investment toward European partners” (“No residence,” 2012). This ominous statement implies that after the conference federal investment and attention will turn away from the RFE. Nonetheless, the state owned *TransNeft*, responsible for the national oil pipelines, has fully funded the giant clamshell shaped ultra-modern aquarium under construction on Russkiy Island. This project was planned and approved by Putin himself, and has already cost over \$110 million (“Transneft Funds,” 2012). The favoring of this project, which stands to incur heavy costs to the region for upkeep, over providing useful social services and the corresponding jobs a hospital would create, draws concern to the long-term intention of current investment projects and how they will affect living standards in the region.

Residents of Primorsky Krai have expressed indifference towards the developments of the Conference and concern that the investments will not provide the promised long-term benefits to the region. It is difficult for them to see the correlation between their lives and the completion of the projects for the summit. In the present period, the interminable period of construction and reconstruction in the city has put a heavy toll on Vladivostok residents. The success and timeliness of completion of APEC Summit projects are widely touted in the local media, and residents are aware that these developments have put them into the national spotlight. Despite the government’s attempts to attract Russians and foreigners to the region, the average stable yearly population has been in continual decline (see Figure 15 below). The *Federal*

Strategy 2025 is therefore failing its primary goal of establishing a stable and economically active population in Primorsky Krai and the RFE at large. Figure 16, below, shows the continued prevalence of foreign import markets over foreign export markets; this high reliance on foreign goods in the region calls into question the motivation for attempting to expand settlement and migration to the area.



## Chapter 5: Conclusion

The current investment program appears to be addressing the symptoms rather than the unique causes of economic distortions in the RFE. Peculiar growth patterns during the Soviet period left the area predisposed to higher costs of living. The harsh climate and distance from the center increased costs associated with reliance on central state support, resulting in poor living standards. Regions closer to the center have historically held political favor and attracted the majority of investment in the post-Soviet period. After many years of empty promises the federal money pouring into Primorsky Krai in support of the *Federal Strategy 2025* is a truly new development. Yet, although federal support holds promise for meaningful change in the region, investments alone do not address underlying issues that require structural and administrative reform. A bottom up approach would better guarantee the future ability of the region to support self-sustaining economic centers of specialization.

The long term failure of development and investment in the RFE is characteristic of shortcomings of economic reform in Russia as a whole. The process of recentralization and the creation of a power vertical structure provided stability, but have weighed against the creation of free market conditions and private property ownership rights. Despite presidential rhetoric over efforts to create special economic zones and regional specialization in the RFE, actions of the central government have yet to include reforms that create market supporting institutions or encourage investors that the future of Russia is reliable and secure.

Russian journalist Andrei Kalachinsky described his amusement at foreign reporters whose first question was always about the corruption in the RFE. Kalachinsky explains, "The president of the country twice approved Darkin as governor of Primorsky Krai. He had sufficient

information and power to know everything about Darkin and forgave or forgot his sins. It is strange to think that Darkin was more criminal in Primorye than say, Luzhkov was in Moscow” (2012).<sup>28</sup> Politicians like Darkin appeal to the Kremlin because their backgrounds contain grounds on which they can be blackmailed or threatened, giving Moscow ultimate control (Gaddy and Ickes, 2010). Thus, while restoring the reputation of Primorsky Krai has been a stated goal of Russian leadership, known patronage networks have been allowed to continue their influence in the area.

Former Primorsky Krai Governor Darkin is an example of this behavior. It was rumored that his dismissal had to do with his local unpopularity and accusations of corruption. A Vladivostok businessman notoriously accused Darkin for the strong presence of corruption in Primorsky Krai during a televised 2007 question and answer session with then-president Putin. Despite this and other direct appeals to high level leadership, Darkin stayed in power for five more years. His February 2012 dismissal corresponded rather with a demonstrated low level of support for Putin’s United Russia party in the December 2012 parliamentary elections. Russian leadership relies on local political actors to drum up support for central goals, and the decision to replace Darkin appears to relate to flagging central support in Primorsky Krai instead of from concerns about local leadership.

Aside from the need to establish a transparent local government, this government also needs to have real power to administer to regional needs. The local government of Primorsky Krai is partially responsible for the implementation of the current large-scale investment projects, but had little influence over what was built and why. The federal government drafted

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<sup>28</sup> Luzhkov, now retired from politics, was a prominent politician throughout the 90s and early 2000s as the Mayor of Moscow. He is widely believed to be implicit and active in widespread corruption in the city. See the New York Times biography for a brief and unbiased biography: Yuri M. Luzhkov, 2011.

the *Federal Strategy 2025*, and it was ultimately the federal government that chose to construct expensive projects in remote locations (over simply building conference facilities on the Vladivostok mainland). The razing of Russkiy Island is reminiscent of Soviet adventurism—professors in Vladivostok predict a certain decline in interest in the island following the conference when residents deal with the reality of a long commute in extreme weather conditions (“*Eksperty obsuzhdaiut,*” 2012).<sup>29</sup>

Lacking true representative structures, it is difficult for the center to administer economic reforms tailored to regional problems as federal representatives are unable to gather all necessary information to make well-informed economic decisions. Information asymmetry problems as described by Stiglitz (1990) will continue to persist until local power structures can make more decisions locally. As it is physically impossible for Moscow to collect the necessary information to make well advised economic decisions for the periphery regions, the likelihood agency problems (local actors distorting information to their personal benefit) and inefficient allocation of resources increases. Unfortunately, the prospects for grass-roots, bottom-up economic development are stymied by the lack of access to working capital and the lack of reform to ease entry into the market and stimulate regional centers of specialization.

The implementation of the APEC investments demonstrates the modus operandi of doing business in the RFE today. Without easing barriers to market entry (both locally and allowing for more involvement of non-state related foreign investment) business will continue as usual. In this way, the current program mirrors the least effective aspects of Soviet central planning:

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<sup>29</sup> The reasons they cite include the unfavorable climate, the lack of unique natural resources, and the lack of interest in tourism to Vladivostok.

- Overinvestment in short term projects at times of financial difficulties: APEC projects, and their associated uncertainty of returns, went ahead during the worst of the global economic crisis when funds could have been invested more prudently
- Investment in infrastructure and new facilities with little or no regard to comparative advantage: investments reliant on large subsidies ignore true input costs and create continued reliance on state support
- Asymmetrical information: producing supply without taking demand into account, such as the construction of a giant university in face of a declining student population or the construction of luxury auto production for remote markets
- Failure to consider long term profit return to the region: minimal job growth, contracts awarded through patronage networks, majority of investments provide returns to state-owned enterprises

Indicators suggest that despite federal investment, the region will continue to be dependent on government subsidies and will face difficulties attracting foreign investment. Capital investment from the center will provide short term relief and benefits to local residents, but does not inherently encourage future growth. The implementation of the APEC projects demonstrates that the business environment remains difficult for foreign investors and Russians alike. The increased role of federal authorities, state-owned monopolies, and “private” firms with close ties to state ownership raise the issue of whether local residents will benefit from trickle-down effects. If government policies continue to favor unofficial markets, social services in the region will remain underfunded.

Is Russia building the bridge to nowhere in the RFE? The bridge to Russkiy Island, and the path to the 2012 APEC Conference is certainly leading somewhere. But the real concern is

whether this future destination will be able to prosper in the highly regulated and risky economic climate of the region. Without undertaking structural reform from the bottom up to create credible, reliable, and respected judiciary, enforcement, and regulatory institutions there is no reason to believe that current investments will wean the region from future reliance on the center. Enforceable and fair systems would create incentives for regional players to invest their profits back into the region to support future growth. In the present period FEFU on Russkiy Island, the bridges across Vladivostok, the renovated infrastructure, and the reconstructed facades threaten to become another white elephant – similar to the huge military-industrial complex left behind by the Soviets – that becomes a burden rather than a boon to the regional economy.

**Table 1. Evaluation of the Action Plan of the Federal Strategy for Social-Economic Growth of Primorsky Krai to the year 2025**

ACTION PLAN OF FEDERAL PROGRAM	MEASURES ENACTED	CURRENT RESULTS
<p><b>Develop the Energy Industry</b>            Implement a region wide program for gasification; attract investment partners in the energy sector</p> <p>Create a large gas &amp; oil processing complex            Implement training program for workers</p>	<p><b>Measures Realized/Began as of 2012</b>  <i>Gazprom: \$7 bill Liquefied Natural Gas Plant</i> (joint stock venture with Japanese government)</p> <p><i>Gazprom: Vostochny Petrochemical Co.</i>  <i>RusHydro: Transition of Vladivostok TETs-2 from coal to gas; complete transition projected by 2013</i></p>	<p><b>Effects of Measures Realized/Began</b>            State owned company, profits accrue to center; example of Sakhalin suggests little trickle down wealth or social welfare increases</p> <p>Continued reliance on foreign expertise/capital</p>
<p><b>Develop Transport-Logistics Management Sector</b>            Develop transport/logistics systems</p> <p>Create port zone at Vostochny-Nakhodka</p> <p>Attract strategic investment partners for infrastructure</p> <p>Establish specialization in Vladivostok ports (container ports, automobile ports, passenger ports)</p> <p>Normalize custom procedures/laws with Asia Pacific countries</p> <p>Create government owned shipping companies</p> <p>Coordinate growth of transport corridors: Vladivostok, Vostochny-Nakhodka, Southern</p> <p>Attract foreign investment to Vladivostok international airport</p> <p>Complete renovation project of Vladivostok Airport</p>	<p><b>Measures Realized as of 2012</b>            Construction of bridges for APEC Conference; rebuilding of roads</p> <p>Remodel of Vostochny-Nakhodka port after remodeling to serve as oil transit point</p> <p>\$135 mill., 7 year loan to develop Far Eastern Shipping Company</p> <p>Russian Railways investing in infrastructure with goals of reducing cross country travel time from 9 to 7 days, new IT structures to reduce customs time</p> <p>Rebuilding roads to/from airport and in central areas</p> <p>Completion of updates to airports and addition of new flights in and out of Vladivostok</p>	<p><b>Effects of Measures Realized/Began</b>            Negative effects of reconstruction during renovation process; questionable ability to maintain completed infrastructure projects; wasted capital in implementation process</p> <p>200 new jobs; increased transport capability; questionable ability to maintain infrastructure/direct profits to local investment</p> <p>As of 2010, FESCO still unprofitable; good potential for future growth</p> <p>As of 2010 only 2.4% of container traffic is transfer; continued need to attract transit containers and make shipping through Russia more attractive</p> <p>Need to attract increased business/tourism traffic to maintain modernized infrastructure</p> <p>Favors state control of economic decisions, profits would accrue to the center</p> <p>Need to attract increased business/tourism traffic to maintain modernized infrastructure</p>
<p><b>Develop Value Added (Processing) Sector for Natural Resources</b>            Improve forestry infrastructure, build logging roads in northern Primorsky Krai</p>	<p><b>Measures Realized as of 2012</b>            Introduced tax on round logs to discourage unprocessed exports of forest resources</p>	<p><b>Effects of Measures Realized/Began</b>            High export taxes and poor options for local processing favor exporting round logs on the unofficial market</p>

Promote certification of forest resources		Continued uncertainty of ownership, government control of resources
Create large processing complex for forest resources		Majority of exports continue to be round logs; difficulty competing with existing Asian-Pacific markets
Create fish processing zone around Vostochny-Nakhodka port		Difficulty competing with established Asia-Pacific brands
Create fish processing center; promote certification and auditing efforts; build biotechnopark; support growth of aquaculture	Repeal of fish auction quotas	Difficulty competing with established Asia-Pacific brands
Normalize law for agricultural enterprises; promote organic agriculture, build agro-industrial park		Existing laws continue to favor government control, limit property ownership and access to credit
Expand mineral extraction activities		TBD, potential for private growth
Promote Primorsky Krai brands of processed natural resources to European and Russian markets		Difficulty competing with established Asia-Pacific brands
Improve education of Russian specialists		If successful, integration with Asia-Pacific educational systems will allow FEFU to fulfill this goal

**Develop Ship Building, Ship Repair, and General Construction Sectors**

**Measures Realized as of 2012**

**Effects of Measures Realized/Began**

Create a Pacific Ocean center for biotechnology, underwater robotics, nanotechnology	Construction of FEFU	TBD, should be possible due to comparative advantage of this kind of studies/specialization in the region
Biotechnopark for foreign funded feasibility studies Yearly conferences with international participants focusing on technological innovations of Primorsky Krai	Feasibility studies for LNG plant	TBD if this will extend outside of energy industries APEC 2012 has potential to build business travel
Create small business consortiums	Promotion of small businesses not favored during contracting for APEC Summit construction	Continued reliance on relationship capital (see Ch. 3-4 for discussion of contract allocation for APEC projects)
Integrate technological developments with Asia Pacific countries	Joint studies with Japan for LNG project	TBD if this will extend outside of energy industries
Develop information sharing and business ties with Asia Pacific countries	Joint studies with Japan for LNG project	Continued reliance on foreign expertise in industry
Create center of commercialization and marketing for technological innovations		Need to first establish Primorsky Krai as a center of innovation
Region wide program to stimulate demand in construction	Construction of objects for APEC 2012 Summit	Ability to produce construction materials still weak; majority of materials imported from central Russia for APEC projects; lack of housing for migrant workers
Construct homes for regional/municipal government employees		Inability to provide adequate housing to migrant workers or those displaced by APEC construction projects

**Develop Tourism Sector**

Create gambling zones

Attract business tourism, raise status of events taking place in Primorye

Build tourist information centers in cities meeting international standards

Build cultural-historical tourism : reconstruct historical areas, preserve unique architecture, develop/improve passenger port to attract tourists

Improve security/safety in Primorsky Krai

Coordinate growth of service sectors (food, trade, tourism services), city and intercity transport systems

Establish PR company to market tourism in Primorsky Krai domestically and internationally

**Attract Investment**

Normalize legal base, reduce administrative barriers to investment

Monitor effectiveness of legal systems in attracting investment

Develop list of attractive projects for public-private ownership, promote the most promising at the federal level

Create agency for regional growth, monitor indicators of effectiveness and results

Market investment opportunities to domestic/foreign markets; neutralize negative image of Primorsky Krai

Establish a PR company to market opportunities, create websites detailing investment potentials, develop/distribute investment memorandum

**Measures Realized as of 2012**

Preparations for APEC Summit

Reconstructing historical façade of Vladivostok, rebuilding central roads and connection to airport

**Major Investment Projects in Primorsky Krai**

Mazda-Sollers to expand plant in Primorsky Krai

Gazprom/Japan LNG development

APEC 2012 Conference to take place on Russkiy Island

**Effects of Measures Realized/Began**

Risk increased crime, alcoholism, negative social qualities

Will depend on the questionable ability of the region to maintain facilities without federal support and gain sustained interest of foreign investors *outside* of the energy sector

Limited access in region of information in foreign languages, little tourist infrastructure

Number of crimes has been decreasing since 2006, still about 2000 level

Focus has been on government funded infrastructure development; variety/quality of other necessary sectors in hospitality/private investment have lagged

Focus has been on APEC 2012 Summit, predicted difficulty retaining interest in the region after the Summit

**Effects of Measures Realized/Began**

As of 2011 the plant employed about 700 people, produced largely for Central Russian market

State owned company, profits accrue to center; capital intensive, unlikely to create large number of jobs for domestic market

Extends focus on federal control of economic development in Primorye; central government will continue to be the primary investor

Encourages state control of economy

EBRD reports, local news coverage, international media, *Wikileaks*, etc. suggest Primorsky Krai is still considered to be largely corrupt

Will require maintenance of infrastructure built for APEC Conference, as well as additional conference facilities

Encourage small-medium sized business: offer microcredit, create regional venture capital fund, subsidize interest rates for bond loans, attract grants, offer tax holidays

Support industries of Primorsky Krai in bids for multi-national projects

### **Stabilize Demographics**

Build transport/communication infrastructure in region

Build high speed train between Vladivostok and Usuriisk, Vladivostok and Nakhodka, etc

Establish Far East Federal University (FEFU) as a prestigious university to attract/develop human capital

Integrate educational systems with Asia Pacific countries; support continued/professional education

Improve occupational safety and industrial culture

Program to provide/construct homes for young families

Public campaigns on health issues, narcotics use, healthy lifestyles and traffic safety

Attract medical specialists and skilled workers to the region; establish programs to help migrants acclimate to life in Primorye

Increase access to preschool, attract higher quality preschool workers

Construct new hospital, develop skills of health care personnel

Develop and invest in cultural institutions

Complete program to provide Primorye with clean drinking water by 2010

Implement "Clean Primorye" program between 2009-2020, promote ecological awareness

Attract migrants to region; develop entire region not focused in southern area

*Adapted from Appendix 1 of the Official Federal Program*

Focus of Russian presidency of APEC Summit on need to improve Russian access to/understanding of financial markets has potential to manifest in increased access to credit on a local level

APEC contract dispersion suggests that businesses with strong ties to regional/federal officials have much better access to these contracts

### **Measures Realized as of 2012**

Investment in international airport and connecting roads

Completed construction of new FEFU campus on Russkiy Island

Social services cut during APEC budgeting

Building of new hospital canceled due to budget constraints

Social spending cut from APEC budget

Construction of water processing plant

Migrant workers provided much of labor for APEC construction, largely from China/Central Asia

Small business continue to report difficulty with administrative procedures, confusing administration, burdensome taxation, difficulty accessing credit.

Need to ease barriers to market entry and establish transparent auctions for contracts

### **Effects of Measures Realized/Began**

Region will need to attract foreign students to support institution

TBD, depends on success of FEFU to adhere to international educational standards and attract foreign students

Protests of Russkiy Island workers suggest working conditions remain poor

Reports of poor quality relocation homes offered to residents displaced by bridge construction

Continued difficulty attracting highly skilled workers, continued difficulty with people leaving the region.

Cases of fraud in 2010's regarding promises of increased social services

Continued difficulty attracting highly skilled workers

Will require future public/private investment

TBD, reports of illegal dumping despite introduction of new waste management facility

Continued difficulties securing nuclear waste; continued high emissions; continued problems with illegal dumping

Continued difficulties attracting highly qualified migrants, migrants from other regions of Russia

**Table 2. Foreign Investment Projects Located In Primorsky Krai**

<b>PROJECT</b>	<b>RUSSIAN PARTNER</b>
Petrochemical Complex Vostochny Petrochemical Company, Nakhodka	<i>Rosneft</i> , state-owned oil company
Natural Gas Extraction Plant, Khasanskii Raion, Perevoznaya Bay	<i>Gazprom</i> , state-owned gas monopoly
Gas Chemical Plant	<i>Gazprom</i>
Mineral processing plant	<i>Gazprom</i>
Construction of Usurissyk Thermoelectric Plant	JSC "RAO Energy System of East," majority owned by the Russian Federation under jurisdiction of the Federal Agency for State Property Management
Construction of Nakhodka Thermoelectric Plant	<i>Gazprom</i>
Gaming Zone in Primorye	Agency for Development of special economic zones; <i>Nash Dom- Primorye</i> , state-owned mortgage lending/construction firm
Creation of Tourist Recreation Zone in VVO	Agency for the development of Tourism and Recreation Zones and gambling in Primorsky Krai
Agro-technology complex focusing on energy conservation	JSC Green Leaves, private company
Technopark in Vladivostok	Department of Communication of Primorsky Krai
Construction of Engineering Center in Vladivostok	JSC "Far Eastern Center of Shipbuilding and Ship Repair," private company
Construction of lighting based on LEDs	JSC " <i>Dalpribor</i> ," private company
Construction of a Medical Center in Vladivostok	OOO "Rhythm 10," private company
Construction of pig farm, processing plant in Artem	Agricultural processing center " <i>Podgorodnensky</i> ," public-private partnership
Development of commercial farms for sea farming	Ltd. <i>NPKA "Nereida</i> ," private company
Improving cancer diagnosis and treatment facilities	Ministry of Health, Vladivostok
Constructing FEFU with focus on energy efficiency and alternative energy sources	Ministry of Education and Science, Ministry of Energy, Russian Federation
Research and develop renewable energy systems	Ministry of Education and Science, Ministry of Energy, Russian Federation
Develop unmanned underwater exploration/mapping systems	The Ministry of Education and Science, Russian Federation
Production of chemicals for agricultural use	To be determined
Improve water purification for agriculture	<i>Rosneft</i>
Marine biotechnopark	Far Eastern Department of Russian Academy of Sciences
Construction of a methanol and natural gas plant	To be determined

\*Highlighted projects indicate majority government ownership

Data adapted from the Ministry of Foreign Affairs of the Russian Federation, available [www.vladivostok.mid.ru/inv\\_02.html](http://www.vladivostok.mid.ru/inv_02.html)

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