

# Russian-Chinese Trade, Investment and Energy Cooperation: Mutual Interests and Mutual Distrusts

Hongmei Ma

## 1 Introduction

After two decades of bitter confrontation, Russia and China normalized their bilateral relationship in the 1980s, and in the nineties made dramatic improvements in their bilateral political and security relationships. In April 1996 the two countries for the first time announced the development of their “strategic partnership”. Followed in 2001, the Treaty on Good-Neighborliness, Friendship, and Cooperation, signed by Russian President Putin and his counterpart Jiang Zemin, codified the bilateral ties and the future of the essential equality of the two states. Then in October 2004, the two countries finally resolved the last of their long-standing border issues. Since then China and Russia improved their relations markedly in 2005.

Regarding the economic relationship between Russia and China, some students of the Sino-Russian studies have pointed out that the economic relationship is the weakest link in bilateral ties<sup>1)</sup>. Nevertheless, economic cooperation is becoming a

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1) Sherman Garnett [2001] “Challenges of the Sino-Russian Strategic Relationship”, p. 46, *The Washington Quarterly*, Autumn 2001; and Yu Bin [2005] “China and Russia: Normalizing their Strategic Partnership”, p. 238, *Power Shift*, Edited by David Shambaugh, 2005, University California Press.

more and more important domain in the Sino-Russian partnership. This paper examines the main features of Sino-Russian economic relationship: trade, investment and energy co-operation, identifies the problems, and anticipates the prospects. While highlighting the wide range of common interests involved, the paper investigates the stumbling blocks for the future development of Sino-Russian economic relations. Furthermore, ironically, the rapid development of economic cooperation, in the Chinese leaders and scholars' views, are mutually beneficial, however, there are suspicions in Russia that China is getting the bigger part of the cake and China would harm Russia's interests in the long term. The "fear of China" could make the future economic relationship become problematic.

## **2 Trade development and its problems**

### **2.1 Trade development**

As the Sino-Russia relationship improved in the beginning of the 1980s, both governments agreed to restart the border trade which had been stopped for more than two decades. In 1982, the two governments signed an agreement to restore the validity of the 1958 trade agreement. Since then, trade volume started to increase.

In the early 1990s, traders were allowed to travel across the border without visas. This facilitated border trade to expand and it did expand rapidly between the Russian Far East (RFE) regions and the adjoining Chinese regions, most notably with Heilongjiang province. Another factor that contributed to the trade expansion was that after the collapse of the USSR in December 1991 the central subsidies that had previously sustained these regions were cut drastically, and the local populations found themselves turning to foreign trade to find the most basic necessities. As a result, they became increasingly, and in some cases entirely, dependent on Chinese goods brought over by shuttle traders (*chelnoki*). Initially, the Russia regions near the border welcomed the rapid opening of border trade to address their economic

needs, however, poor regulations on both sides enabled criminals and unscrupulous business people to take advantage of the sudden opening of the border. The new markets catering to the shuttle trade soon became associated with criminal activity. According to Minakir, criminal activity in the border region peaked in 1992, and was popularly attributed to the growing influx of Chinese. In fact, however, the Chinese turned out to be the victims of criminal racketeering, and not the source. Many inexperienced Russian firms participated in the mad rush to the border, leading to vociferous complaints in the RFE about shoddy goods and unscrupulous Chinese traders. Chinese traders also accumulated their own list of complaints about the difficulties of doing business in Russia due to the unstable economic environment and pervasive corruption<sup>2)</sup>.

The extremely disorderly nature of the transactions and rising crime rates led Russian authorities to impose border controls in 1993 and to conclude an agreement with Beijing in 1994 to establish formal border-crossing posts and tighten visa restrictions, causing a sharp reduction in Sino-Russian trade which had reached \$ 7.68 billion in 1993 (second only to the level of Russia's trade with Germany the same year), to fall to \$ 5.08 billion the following year, a decrease of 36.5 per cent<sup>3)</sup>. Sino-Russian trade dropped further by 34 per cent in 1994. Because traditionally, cross-border trade (including shuttle trade) constituted a third of the bilateral trade, and cross-border trade is linked closely with the mobility of traders from both countries.

As Table 1 indicates, the bilateral trade recovered somewhat in 1995, reaching

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2) Minakir, Pavel A. [1996] "Chinese Immigration in the Russian Far East: Regional, National, and International Dimensions", *Cooperation and Conflict in the Former Soviet Union: Implications for Migration* Edited by Jeremy R. Azrael, Emil A. Payin, Kevin F. McCarthy, and Georges Vernez, Rand Cooperation.

3) "Bilateral Economic and Trade Relations and Economic and Technological Cooperation." Chinese Embassy in the U. K. <http://www.chinese-embassy.org.uk/Diplomacy/Sino-Russian/BETRETC.htm>. Accessed on March 20, 2004

\$ 5.46 billion, and it rose to \$ 6.85 billion in 1996. However, trade turnover has not reached the 1993 level, remaining in the \$ 5 - 6 billion range. After the meeting between the Premier Ministers of China and Russia in December 1996, it was announced that the two countries' targeted level of trade would be \$ 20 billion annually by year 2000<sup>4)</sup>. However, because the Russians did not reduce the barriers on the border, the trade expansion was insignificant. In 1998, the Russian economic crisis compounded the problems of high transportation costs and low population densities in the RFE to leave the provinces of Northeast China with little hope for their exports<sup>5)</sup>. In the beginning of 1999, high-level exchanges of top trade officials were realized. "Commercializing" Russian-Chinese relations, therefore, assumed an important and strategic significance<sup>6)</sup>.

**Table 1 Chinese-Russian Trade 1992-2005**

(in US\$ billions)

Year	Export	Import	Total
1992	2.336	3.526	5.862
1993	2.691	4.988	7.679
1994	1.581	3.495	5.076
1995	1.665	3.798	5.463
1996	1.693	5.153	6.846
1997	2.032	4.086	6.118
1998	1.839	3.641	5.480
1999	1.497	4.222	5.720
2000	2.233	5.770	8.003
2001	2.710	7.959	10.669
2002	3,521	8,407	11,928
2003	6,030	9,728	15,758
2004	9,098	12,127	21,225
2005	13,211	15,889	29,110

Source: Chinese Customs Statistics.

4) Xinhua News Agency "China and Russia agree to build strategic partnership" (as provided by BBC Worldwide Monitoring). November 18, 1996.

5) Rozman, Gilbert [2004] *Northeast Asia's Stunted Regionalism*, p.214, Cambridge University Press.

After years of mutual efforts to boost bilateral economic relations, a rise in trade finally registered in 1999. Since Putin's presidency, trade has been rising significantly. During the past five years, the value of Sino-Russian trade has grown an average 20 per cent annually. In 2005, the trade turnover was up by 37.1 per cent over 2004 (\$ 29.1 billion). China is Russia's fourth-largest trading partner. And Russia is China's eighth-largest trading partner, Russia ranks as the second largest trading partner among China's European trading partners (after Germany and ahead of Britain). Even though bilateral trade volumes amount to only about one tenth of China's trade with the United States or with Japan. However, to be fair, taking into account the fact that China's foreign trade is increasingly linked with transnational investment, and the Russian investment in China is quite limited, the Russia-China trade could be viewed as "ordinary" trade or "pure" trade.

However, the growth of bilateral trade must not be taken at the face value. This is because the significant bilateral trade turnover growth in 2005 was mainly due to high global commodity prices. For example, in 2005, crude oil deliveries to China totaled 12 millions tons, up 13.2 per cent in terms of volume but 62 per cent higher in terms of value. The deliveries of crude oil to China accounted for 50 per cent of the value increment in trade turnover between the two countries. And other Russian export items also mirrored this trend. Russian petroleum products exports to China were down by 4 per cent year-on-year in volume, but were up by 36.6 per cent in value. Likewise, calcium chloride exports were up by 0.4 per cent in volume, but 31 per cent in value. As Russian exports to China remain dependent on international commodity price movements, Russian officials are wary of a possible global commodity downturn. These numbers make analysts wonder how bilateral trade turnover could be increased to \$ 60-80 billion by 2010 which was set

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6) Yu Bin [1999] "NATO's unintended Consequences: A Deeper Strategic Partnership...or More", p. 68, *Comparative Connections*, Vol. 1 No. 1.

as the trade targets by authorities from the two sides, particularly in the event of lower global commodity prices<sup>7)</sup>.

## 2.2 Trade Structure

Russia and China welcomed the expansion of the trade, however, Russian officials complained about the unbalanced trade structure between the two countries. According to the Russian trade representative in China, Sergei Tsyplakov, in 2005, oil and oil products amount to half of Russian exports to China, and unprocessed wood makes up another 25 per cent. On the other hand, Russian machinery amounts to a mere 1.2 per cent of Russian exports to China<sup>8)</sup>. According to the Chinese statistics, as shown in Table 2, in 2005, oil and oil products amount 41.6 per cent of Russian exports to China, and wood makes up another 11.4 per cent. Russian machinery amounts to a mere 1.1 per cent of Russian exports to China.

However, Russia is hardly in a position to complain. In 2005, in Russia's total export to the world, oil and oil products amount to 64.3 per cent and wood and

**Table 2 Commodity Composition of Chinese Imports**

	2000	2001	2002	2003	2004	2005
Seafood (3)	6.5%	6.3%	7.5%	6.5%	6.4%	6.9%
Fuel/energy products (27)	14.9%	9.9%	14.4%	20.8%	34.5%	41.6%
Fertilizer (31)	10.6%	7.6%	10.5%	6.7%	7.9%	8.2%
Forestry, pulp and paper products (44)	7.5%	7.7%	12.8%	10.5%	11.9%	11.4%
Steel (72)	15.0%	14.9%	11.6%	16.5%	11.8%	11.0%
Aluminum (76)	16.3%	2.6%	0.9%	2.1%	2.2%	0.7%
Machinery and mechanical devices (84)	1.8%	3.8%	8.0%	6.0%	1.3%	0.5%
Transport vessels (88)	1.0%	19.0%	11.9%	5.3%	2.5%	0.9%
Optical goods (89)	0.1%	4.6%	0.0%	0.1%	0.0%	0.2%

Source: Chinese Customs Statistics, Calculated by the author.

Note: Commodities are classified according to International Trade Centre (ITC) HS-Codes (Harmonized System Codes).

7) Interfax, January 19, 2006.

8) Interfax, June 5, 2006.

pulp consist of 20.4 per cent. Meanwhile, Russian machinery and transportation equipment amount to 1.0 per cent<sup>9)</sup>. So the conclusion is that in general, the commodity composition of Russian exports to China conformed to Russia's global trade profile as a supplier of raw materials, metals, and semi-processed goods.

Regarding the commodity composition of China exports to Russia, it is not conforming to China's global trade profile. However, it is on the way of converging to it.

As Table 3 indicates, China exported mainly consumer items to Russia: almost 56 per cent of Chinese exports to Russia in 2005 were textiles, textile products, leather goods, and shoes. It was not surprising because China was internationally recognized as a leading exporter of textiles and related products. However, textiles and related products comprised only 16.9 per cent of China's total exports mix in the year 2005<sup>10)</sup>. With rapid industrialization, China is improving its export structure. China's largest export category in 2005, consisting of 46.2 per cent, was machinery and mechanical devices (including electronic goods, TV, etc.). In

**Table 3 Commodity Composition of Chinese Exports**

	2000	2001	2002	2003	2004	2005
Leather (42)	20.5%	19.8%	14.2%	15.8%	13.2%	9.1%
Fur (43)	1.8%	2.4%	2.2%	5.9%	13.3%	12.9%
Apparel (61)	10.9%	7.0%	7.8%	8.6%	9.1%	8.1%
Apparel (62)	15.4%	12.5%	12.5%	13.4%	8.0%	12.4%
Textile Fiber (63)	1.9%	3.0%	1.6%	3.3%	3.3%	4.3%
Footwear & parts thereof (64)	15.5%	14.9%	14.7%	9.2%	6.5%	8.8%
Equipment (84)	2.7%	3.7%	5.7%	6.0%	6.2%	6.5%
Electrical machinery & equipment (85)	4.1%	5.9%	8.9%	9.2%	9.7%	10.2%

Source: Chinese Customs Statistics, Calculated by the author.

Note: Commodities are classified according to International Trade Centre (ITC) HS-Codes (Harmonized System Codes).

9) JETRO (Japan External Organization) [2006] *Trade and Investment White Paper*, p. 337.

10) *Ibid.*, p. 157

2005, Exports of high-tech products (a general term China customs use which includes a variety of products such as computers, electronics, aerospace technology, and telecommunications equipment, among others) grew 31.8 per cent in 2005, accounting for 28.6 per cent of all of China's exports. Nowadays China is not only capable of manufacturing machine equipment, household electronics, and chemistry industry, but is also capable of making into the world market. For China's foreign trade experts and officials, the improvement in the economic situation in Russia and the increased purchasing power of the Russian consumers are making Russia an attractive market for good-quality and inexpensive Chinese goods.

However, Chinese exports of these high-tech items to Russia comprised only 16.7 per cent of the exports mix to Russia, and were disproportionately lower than its overall share in the Chinese export mix. Chinese exports to Russia thus tended to concentrated in lower value-added sectors, absent the range of products that exported to higher-income economies such as the U. S. and Japan. However, high-tech items exports to Russia are increasing rapidly, by nearly 60 per cent in 2005.

On the Chinese import side, among China's top 10 imports by value, the commodities that saw the highest growth in 2005 were base minerals used in smelting, and mineral fuel and oil. Chinese imports of ore, slag, and ash commodities rose by 50.6 per cent in 2005, and mineral fuel and oil commodities increased by 35.5 per cent. The fact that these commodity groups saw the largest amount of growth over the past year indicates that they are increasingly important to China's economy and the import potentials will be enormous.

From Table 2 and Table 3, we can see the tendency that the commodity composition of imports and exports between Russia and China is converging to their profiles in the world market. Taking account of the future needs of both countries, this tendency will be growing.

During President Putin's visit to China in March 2006, he expressed concerns

about the “raw material bias of Russian exports”. As argued by Lo, “His comments reflected not just a fear that Russia was being left behind in the race for global economic competitiveness, but more specifically that it was being overtaken by China, a developing country”<sup>11)</sup>. The Russian president urged the Chinese to reverse the downward trend in Russia’s machinery exports to China. President Hu, however, believed that Russian enterprises were “fully capable of achieving a bigger market share” in China “if they can bring their advantages into play and come up with competitive products and technology.” In one of the five proposals he made at the forum, Hu pointed out that enterprises should be the “main force in the strengthening of international economic and technological cooperation,” and governments should play a supportive and facilitating role “in their efforts to unfold mutually beneficial cooperation at different levels and in diverse spheres.” “I sincerely hope that entrepreneurs in both countries would seek more partners, look for more opportunities, cooperate more and make still greater contributions in further promoting Sino-Russian economic and technological cooperation and promoting the development of strategic partnership between the two countries,” noted Hu. Vice Premier Wu Yi, chairperson of the forum, too, urged cooperation between large companies of the two countries, especially on large projects<sup>12)</sup>. In the eyes of the Chinese, the real problem of “unbalanced trade structure” cannot, and should not, be resolved solely by governmental regulatory means. In fact, the lack of competitiveness of Russian finished products is the key to the declining role of Russia’s machinery products in bilateral trade. Russian researchers have realized and pointed out that the reason for the small share of machinery export to China is that Russia has powerful competitors in the Chinese market, such as Western nations

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11) Lo Bobo [2006] “China and Russia: Common Interests, Contrasting Perceptions”, p. 14. *Asian Geopolitics*, Chatman House.

12) Yu Bin [2006] “China’s Year of Russia and the Gathering Nuclear Storm”, *Comparative Connections*, Vol. 8 No. 1.

and the newly developed Asian countries, which are capable of meeting a large portion of China's import needs, and the majority of these companies have set up their own production lines in China, and have entered into close cooperation with Chinese manufactures. Unfortunately, Russian companies, due to lack of financial resources and poor advertising and marketing, are lagging behind their competitors<sup>13)</sup>.

In the numerous Sino-Russian Joint-communicés, it is emphasized that China would give top priority to expanding economic relations with Russia and pledged to take active measures to increase imports from Russia and make special efforts on cooperation in energy resources, electro-mechanics, and infrastructure construction. While the lack of competitiveness of Russian products in both Chinese and international markets cannot be redressed overnight, official pronouncements are yet to entail any practical results, plans remained for the most part vaguely articulated and undefined. As no new incentives have been introduced recently to raise Russian high-tech exports to China. With the economies of both Russia and China are transiting closer and closer to market economy, the old Soviet style government-to-government trade has lost and will continue to lose its currency.

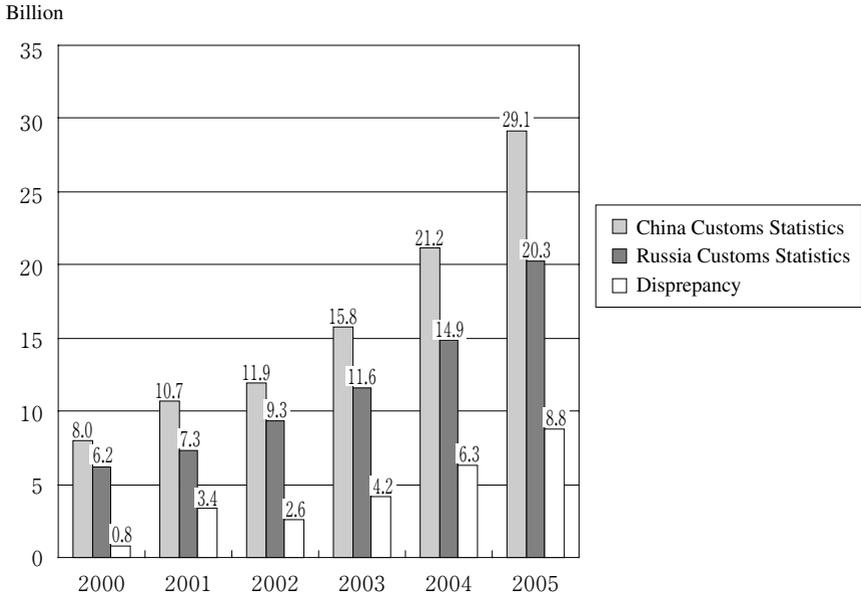
### 2.3 Discrepancies in the Trade Statistics and its Reasons

Since the beginning of this century, the discrepancy between Russian and Chinese trade statistics started to grow larger and larger (see Figure 1). In 2005, it reached \$ 8.8 billion. So far the discrepancy between Russian and Chinese trade statistics has not become a problem but as the Russian trade surplus became smaller (see Figure 1), it could become a controversial issue one day. The worrisome

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13) Tsyplakov, Sergei and Evgeny Popov [2003] "Russian-Chinese Trade and Economic Cooperation: Current Problems and Outlook", p. 70, *Far Eastern Affairs*, Vol. 31 No. 3; Lvishin, Sergei [2006] "2006: The Year of Russia in China: A New Quality of Partnership", p. 12, *Far Eastern Affairs*, Vol. 34 No. 1.

**Figure 1 Trade statistics discrepancy**



Source: Chinese Customs Statistics, Russian Customs Statistics

fact about the trade statistics discrepancy is that it is related to illegal trade practices.

China Customs trade statistics (both the export and import numbers) are larger than the Russia's. The reason is likely related to the newly implemented and stricter Chinese customs controls, and tightening of import formalities on the Chinese side in the most recent 3 - 4 years. Furthermore, normal official Russian trade statistics underestimated, or even could not grasp the volume and value of Chinese exports to Russia, and simultaneously underreported the Russia exports to China. These discrepancies in bilateral trade statistics can be explained by other more complicated factors.

### 2.3.1 Chinese Imports

According to Feng, regarding Chinese imports, most of the discrepancy is found in three items: seafood, timber and metal<sup>14)</sup>.

Seafood imports from Russia, according to Chinese figures, reached \$340 million in 2000. However, Russian figures for the same period indicate seafood exports to China were a paltry \$45 million. The difference was \$295 million. In 2004, the difference had reached as high as \$700 million. The main reason for this discrepancy in seafood trade is considered that the seafood has either changed hands on the waters or Russian boats came to the Chinese port just after fishing, without going through the Russian Customs. In addition, some of these Russian boats had neither fishing permits nor licenses to export their catch. The fact that much of the illegal fishing is overseen or controlled outright by Russian organized-crime gangsters makes it more difficult to gauge the right number<sup>15)</sup>.

In the timber trade, there are not big differences in the quantities but there are big differences in the values. Trade volumes are understated in Russian statistics<sup>16)</sup>. For example, Russian exporters are more likely to understate exports in order to evade export duties or approved quotas. Russian customs have also consistently found evidence of understating export volumes, particularly of logs. On the China side, because the import tariffs on log are set to be zero but Chinese importers must

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14) Feng Anquan [2006] "An Analysis of China and Russia's Trade Statistics-Focusing on the Trade Discrepancies", Reported at The Japan Association for Comparative Economic Studies, 5th Autumn Conference, in Kobe, October 28, 2006.

15) The same tendency was also found in the Japanese-Russian trade. According to Japanese figures, seafood imports from Russia reached \$686 million in 2000. Russian figures for the same period indicate seafood exports to Japan were a paltry \$3 million. The Japan Fisheries Association, meanwhile, estimates the illegal seafood trade between Japan and Russia alone is worth \$1.2 billion a year, in line with the most plausible Russian estimates, in "The Death of Sushi?" *Far Eastern Economic Review*, August 15, 2002.

16) Lankin, Alexey [2005] "Forest Product Exports from the Russian Far East and Eastern Siberia to China: Status and Trends", Forest Trends Working Paper.

pay a value-added tax (VAT) of 13 per cent for logs and 17 per cent for sawn wood, thus, in order to pay less VAT, Chinese importers report their imported goods as logs, rather than as sawn wood. This could be one of the factors which contributes to the understating of sawn wood import volumes.

The big differences in the values could be explained by the Chinese customs' recording method. If the contracted value of log for per cubic meter is below \$ 50, it would be recorded as \$ 50 and then taxed. However, on the Russian side, sometimes in the contract, the value of log was set far lower than its market price. As indicated by Lebedev, "in the most popular illegal export model, exporters label high-quality timber as "pulp logs," in order to reduce the official contract price. This strategy is meant to hide company profit on the Russian side and thereby reduce the profit tax the company must pay to Russia"<sup>17)</sup>. Although the Russian government has set strict export rules, the rules are not fully implemented. "Bribes may be paid to customs officers at the timber yards and to the police, the militia and others to ensure the safe passage of illegally harvested timber"<sup>18)</sup>.

One thing which needs to be mentioned here is the fact that a timber exporting company in Russia and an importing company in China could be the same trade company. Since the late 1980s, the Chinese started to invest in Russia (see below). Most of those enterprises are trading companies. In the RFE and Siberia, some Chinese ventures are engaged in logging and wood-processing trade. In order to pay less tax on the Russian sides, these companies declare less volume and value of the timber. Of course, the Chinese companies pay bribes to Russian officials.

The situation with metal trade is similar, illegal activities are widespread, such as under-declaring export volume and value, mislabeling minerals. This contributed

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17) Lebedev, Anatoly [2005] "Siberian and Russian Far East Timber for China: Legal and Illegal Pathways, Players, and Trends", p. 8, Forest Trends Working Paper.

18) Pye-Smith, Charlie [2006] "Logging in the Wild East: China and the Forest Crisis in the Russian Far East", p. 5, Forest Trends Working Paper.

to another part to the trade statistics discrepancies.

Needless to say, there are certain practical measures that the Chinese government and Chinese traders could take to eliminate the illegal activities, but most of the problems in Russia will have to be solved by the Russians themselves.

### 2.3.2 Chinese Exports

Regarding Chinese exports, most of the discrepancy is found in consumer goods such as leather, fur, shoes, and textiles<sup>19)</sup>. Russian trade statistics did not or could not record the substantial trade in commodities carried across the border through informal channels. These included the shuttle and border trade, forms of barter exchange, and smuggling and illegal unregistered activities. Here, it is necessary to elaborate on the special ways of trading between China and Russia.

#### (2.3.2.1) Shuttle trade

It is nearly impossible to grasp the real trade volume of the shuttle trade. During Chinese Prime Minister Zhu Rongji's visit to Russia in September 2001, he admitted publicly for the first time that its volume goes as high as \$ 10 billion every year. The same trade volume was confirmed by President Putin in May, 2005 in a press conference with Chinese President Hu Jintao<sup>20)</sup>.

Though the shuttle traders helped the Russian people go through hard times, the Russian government viewed the shuttle trade as a "backward" way of trading, and criticized it for bad effects on local industries. So it keeps on putting limits on it. In the beginning, the Russian government allowed duty-free import of goods costing less than \$ 10,000, afterwards it was lowered to \$ 2,000. In 1998, duty-free items were limited to goods \$ 1,000 in value and weighing under 50-kilograms. As a result, a new form of business emerged—cross-border carriers of 50-kilogram goods. Cross-border carriers acquired the nickname of "bricks". "Brick" stands for a

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19) Feng [2006]

20) [Http://russia.shaps.hawaii.edu/fp/russia/20030527\\_press.html](http://russia.shaps.hawaii.edu/fp/russia/20030527_press.html)

carrier and his cargo. 50-kilogram bricks were packed on the Russian side and then sent to various cities, as far as Irkutsk and Yakutsk. Due to the limits on duty-free import of goods, Shuttle traders used to take “helpers”, or “*pomogaiki*”, who were paid by the trip and assisted in carrying goods imported from China without paying customs duties. Needless to say, such shipments were not registered, so officially they did not exist at all. As of late 2001, the law stipulated that if cargo’s weight did not exceed 200-kilograms or if its value did not exceed \$ 10,000, the customs fee is 30 per cent of the value for this type of goods.

It was mentioned that in the Russian Far East, shuttle traders import up to 60-80 per cent of the total amount of clothing and footwear imported in the region. As a result, non-payment of value added tax and custom taxes do not provide equal conditions for local producers, who often have to work illegally<sup>21</sup>. The Russian government decided to change the situation by considerably tightening its policy concerning cross-border shipments.

Russia’s government imposed a new law limiting the amount of goods one can carry into the country without paying customs duties on February 26, 2006, thus striking a hard blow to shuttle-traders. The new rules stipulate that the maximum amount of goods an individual can bring to the country is 35-kilograms of goods per month, decreasing from 50-kilograms per week before. According to the officials, the law is aimed to provide competitive conditions for domestic manufacturers. However, no measures on how to help the numerous shuttle traders are specified, for whom this business has been almost the only way of making a living<sup>22</sup>. In Primorye, the rules of cutting the weight limit will have the most drastic effect on small businessmen, most of them having one or two small shops selling clothing and

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21) Sokolova, Alyona [2006] “New Rules to Choke Shuttle Traders”, Vladivostok News, March 1, 2006.

22) *Ibid.*

footwear with an assortment that has to be renewed at least three times a month. With the new rules, this practice becomes totally unprofitable, consequently businessmen will go to China more rarely and increase prices for their goods. Often Chinese products are preferred by Primorye residents due to their availability and affordable prices. Experts say that the new weight limit imposed on goods can lead to a 30 per cent increase in prices and provoke more bribes to customs officials at the border crossings. At the same time, it will hardly lead to the mushrooming of small Russian enterprises which will be able to overflow the market with affordable and varied goods<sup>23)</sup>.

Since the start of the new rule, sharp decline in the border trade was observed. In the first six months of 2006, the trade between Heilongjiang Province and Russia dropped by 41.78 per cent comparing with the first 6 months of 2005. In the main border check points such as Suifenhe, Dongning and Heihe, trade volume dropped by 49.63 per cent, 21.25 per cent and 85.06 per cent respectively<sup>24)</sup>.

At the same time, it was made public that the Economic Development and Trade Ministry also prepared amendments to the Russian Tax Code stipulating to lower the predicted cost of goods brought by individuals from the current 65,000 rubles (\$ 2,306) to 15,000 rubles (\$ 530) starting January 1, 2007<sup>25)</sup>. If this is going to happen, because of the high tariffs and duties for clothing and shoes, this will give another blow to the shuttle traders and Russian people.

#### (2.3.2.2) Gray customs clearance

Gray customs clearance became a widespread and ubiquitous method in Chinese-Russian trade at the beginning of the 1990s. It was a product of the social changes

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23) *Ibid.*

24) Li Chuanxun [2006] "China-Russia Economic Relations, Latest Developments", p. 3, Reported at Asian Community Research Center Workshop, in Osaka Sangyo University, November 4, 2006.

25) RIA Novosti, February 26, 2006.

which occurred at the onset of Russian perestroika. At that time, in light of the serious shortage of commodities on the domestic Russian market and under the influence of interested groups, the Russian Customs Committee permitted so-called customs clearance companies to provide one-stop services that cover both transportation and customs clearance procedures for the owners of commodities. These services were usually called “chartered truck (flight, container) and customs payment”. In other words, the commodity owner could receive his commodities without paying customs taxes and fees at the usual rates. But he has to pay the customs clearance company an agreed-upon sum. Many Chinese business people often go to the “customs clearance companies” in Russia to cut costs and to improve efficiency<sup>26)</sup>.

The procedure consists of the following stages<sup>27)</sup>:

- (1) Russian and Chinese shuttle traders in a Chinese city deliver the goods they have bought to the warehouse of a freight company that has a license to ship things to Russia.
- (2) The accumulated cargo is written up as export goods from one of the major Chinese import-export companies. Fictitious import-export contracts are signed for this purpose, with the above Chinese corporations listed as one of the parties. Private judicial entities comprise the Russian side. Companies of this type are, as a rule, not destined to live long, and usually expire before their first tax claim is dispatched (three months from their founding date). Their Russian counterparts are drawn up in the names either of people who have already died or of bums.

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26) Li Jinbo and Zhang Chengli [2006] “From ‘gray customs clearance’ to normal trade: the trend of Sino-Russia private trade”, *Russia, Central Asian & East Europe Markets* (in Chinese), 2006 No. 6.

27) Goncharov, S. [2003] “The Chinese in Russia: Who are they?”, pp.35-36, *Far Eastern Affairs*, Vol. 31 No. 3.

- (3) After the goods arrive on Russian territory, they pass through customs by the customs clearance company. Corrupt customs officials stand behind the customs clearance companies, which are carried out so-called customs clearance by means of illegal methods. Cargo pass as at the lowest possible tariff (that of cotton clothing for Children under five, for example). An agreement is struck with customs for even fur coats and leather goods to get such a rate. In actual practice, a fixed sum that remains the same over a certain period of time is taken for each cargo plane. At the very beginning of the 1990s, one Il-76 with such “general cargo” from China was worth \$ 5,000 at Russian airport; today, the price has skyrocketed to \$ 120,000 and will quite probably go even higher. Customs officials are promoting such a situation because their inability to inspect thoroughly, either physically or with technical means, the thousands of bundles arriving by air from China on a daily basis.
- (4) The goods, having already passed through customs, go to a warehouse where they are distributed to their real owners, the Chinese shuttle traders. One must remember a critically important fact: the clearance company, as a rule, could not provide the commodity owners with the necessary accompanying documents and invoices. So commodities arrived at the customs house on what appeared to be legal basis, but in fact they were undeclared contraband. That is, conditions were created for the commodity owners to avoid taxes and other charges at the sales stage, which at the same time because of lacking proper customs documents, these business people are often subject to inspections by Russian police, and their commodities are usually confiscated.

It is obvious that such as transactions are not fully registered for in the customs statistics of both nations. In September 2003, Premier Wen Jiabao and Premier Mikhail Kasianov made a special point of discussing “gray customs clearance” problem in Beijing during the eighth regular meeting. In the joint communiqué, it

was noted in particular that both states should expand cooperation to eliminate abnormal phenomena in foreign trade and create a joint Chinese-Russian working group to regulate trade and to rectify “gray customs clearance”. But this goal has not been achieved yet. Because the “gray customs clearance” described above still has its “raison d’être”: Russian customs officials, the tax and ordinary police, Russian and Chinese shuttle traders, Chinese manufactures, shipping companies and most importantly the buyers of Chinese consumer goods that are not very high quality but are surprisingly cheap<sup>28)</sup>.

Russia alleges that Chinese exports to Russia totaled \$ 3.4 billion in 2003. However, Chinese data indicated the figure is \$ 6 billion. Therefore Russia believed the difference of \$ 2.6 billion entered the country without paying taxes. Moscow unilaterally increased tariffs on imports from China from the original \$ 0.4 to \$ 1.2 per kilogram to \$ 3.5 per kilogram<sup>29)</sup>. This triggered a trade dispute. It is normal that trade fictions occur given the rapid increase in bilateral trade; however, in this case, Russia’s measures not only failed to tackle the basic problem of “gray customs clearance”, but also disrupted the trade development.

### 2.3.3 Arms trade

Another reason for the trade statistics discrepancy is related with the record about arms sales. Unsurprisingly, there is considerable secrecy regarding the level of Russian arms transfers to China.

The Russia’s customs statistics has the category 88, as defined in the International Trade Centre (ITC) HS-Codes (Harmonized System Codes), however the data to show what and how much were exported to which country is not available. For example, in 2001, Chinese customs statistics indicated that China imported almost \$ 1.5 billion of aircraft, spacecraft, and related parts from

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28) Li and Zhang [2006]

29) “Talks Urged over Russian Tariff Decision”, China Daily, April 23, 2004.

Russia, which constituted China's largest commodity purchase of that year. Russian trade statistics, however, omitted this category, resulting in a substantial undervaluation of Russian exports to China<sup>30)</sup>.

Russian-Chinese relations arms trade started in 1992 after Beijing was hit with a US-European arms embargo following the 1989 Tiananmen Square Accident. Since then, Russia has been the main arms supplier to China, and China became the leading purchaser of Russian arms (see Table 4).

For over a decade, Russian military exports to China have constituted the most important dimension of the two countries' security relationship and the largest sector of Sino-Russian trade. Since the two governments signed an agreement on military-technical cooperation in December 1992, China has purchased more weapons platforms and hardware-related items from Russia than from all other countries combined. During the 1990s, the value of these deliveries ranged up to \$ 1 billion annually. In recent years, this figure has approached \$ 2 billion per year<sup>31)</sup>. Needless to say, \$ 2 billion per annum is quite a large proportion of total bilateral trade.

Russia's supply of weapons to China is being driven by market forces and profits in the large part, given Russian defense industry woes and its hope that profits from arms sales might contribute to its own military modernization and reform efforts. But from time to time, Russian critics inside and outside the military have questioned whether contributing to a stronger China is in Russia's interests<sup>32)</sup>. So far Russia has imposed some limits on what it has offered China.

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30) Wilson [2004] p. 65.

31) For a list of major Russian-Chinese military transactions see Alyson J. K. Bailes, ed. [2006], *SIPRI Yearbook 2006: Armaments, Disarmament and International Security*, Oxford University Press, pp. 494-495.

32) For the heated debate in Moscow about arms exports to China, see Azizian, Rouben [2003] "The Optimists Have the Lead, for Now: Russia's China Debate", *Special Assessment: Asia's China Debate*, Asia-Pacific Center for Security Studies.

**Table 4 Arms Transfer to China 1993-2004, by Major State Suppliers (in US\$ millions and as a percentage)**

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	1989-2005 Total	%
Russia				1,096	1,027	79	464	1,066	579	111	1,383	1,700	2,964	2,429	1,997	2,581	2,564	20,040	90.12
Ukraine				42	55	22		83	78	87	97	82	102	118	78	108	83	1,035	4.61
France	34	17	26	10	6	30	16	33	17	9	28	9	9	11	4	26	12	297	1.32
Israel		18	18	18	18	18	18	18	18	28	28	18	18					236	1.05
Germany	12	12	12	12	12	16	12	17	7	12	17							232	1.03
USSR		81	151									12	13	11	13	25	17	232	1.03
U. K.												24	34	4	4	20	20	152	0.68
Italy						5	11	5	3		11		3					64	0.28
USA					1	14	3	3			31							52	0.23
Uzbekistan														73				73	0.33
Japan	15	30																45	0.20
Total	61	168	223	1,178	1,119	184	524	1,225	706	255	1,629	1,845	3,143	2,646	2,096	2,760	2,696	22,458	100.00

Source : SIPRI arms transfer database

Note : Figures are trend indicator values expressed in US\$ millions at constant (1990) prices. SIPRI values indicate the volume of arms transfer, not the actual financial values of such transfers. Percentage extrapolated by the author.

Russian officials claim that the aircraft it sells to the Chinese have less capable avionics and radar packages than in versions provided to the Russian air force. And its arms supplies to China have been inferior to those for other nations, such as India, despite the fact that both Asian nations are Moscow's "strategic partners"<sup>33)</sup>.

China is anxious to avoid becoming dependent on any supplier for its defense needs. But in the absence of the lifting of arms embargo, the Chinese reliance on Russia as its major external source of armament does not appear to abate<sup>34)</sup>. China has made it clear that it is interested in creating "pockets of excellence" weapons; but to do so it must first obtain that foreign technology. China is taking steps to modernize China's military-industrial complex, by pressing the Russians to transfer weapons technology through licensing in preference to sales of military hardware. Not surprisingly, Moscow is reluctant to go down this path<sup>35)</sup>. There are both economic reasons and security reasons. The economic reason is that Chinese engineers might learn enough from the technology to further improve the quality of their indigenous production then China will stop or reduce the arms import from Russia. And even worse for the Russian firms, they could yield their market to lower-cost Chinese suppliers in the international arms bazaar<sup>36)</sup>. The security reason is the changing military balance between Russia and China<sup>37)</sup>. Many Russian policymakers and experts are increasingly concerned at the speed with which China is narrowing the strategic gap. Suspicions about the rise of "China threat" could put a brake on the arms sales and defense cooperation. At the same time, in order to

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33) Yu [2005] p. 240.

34) Wilson [2004] p. 100.

35) For a detailed exploration and analysis of the distrust and tension in Sino-Russian military cooperation, see Ming-Yen Tsai [2003] *From Adversaries to Partners?: Chinese and Russian Military Cooperation after the Cold War*, Praeger publishers.

36) Weitz, Richard [2006] "The Sino-Russian Arms Dilemma", *China Brief*, Volume 6, Issue 22, The Jamestown Foundation.

37) Lo Bobo [2005] "A Fine Balance-the strategic case of Sino-Russian Relations The balance of power", *Russie. Cei. Visions*, No. 1, Institut Francais des Relations Internationales.

retain Russia's share of China's defense market, especially after European countries lifted their embargo on China, Moscow could decide to sell even more advanced weapons systems to Beijing. Russia's dilemma over arms sales to China will become more acute than it is now.

### 3 Chinese Investments in Russia

China first invested in the RFE region as early as the end of 1980s. Due to the geographical proximity, most of the Chinese investment is concentrated in the RFE. There was a real boom at the beginning of the 1990s in the creation of Russian-Chinese joint ventures in the RFE. During 1992-93 there were around 800 Sino-Russian joint ventures in the RFE.

Since the very beginning of their activity in the RFE, Chinese enterprises have been oriented exclusively toward foreign trade (for example, the exchange of Russian raw materials for Chinese food and consumer goods). After the end of the business boom in trade between China and RFE during the second half of the 1990s, the volumes of Chinese investments, which were small anyway, in the region shrank even more, in 1998, the number of the Sino-Russian joint ventures decreased by 25 per cent. And by the beginning of the 21 century the number further decreased<sup>38)</sup>.

Since the beginning of the 21 century, with the upswing of Russian economy and the improvement of investment environment, the numbers of Sino-Russian joint ventures have shown a tendency to increase.

By the end of 2005, the aggregate capital of China in Russia was \$ 465.57 million<sup>39)</sup>. Nearly half of it was invested in 2005 (\$ 203.33 million). Foreign investment in Russia in 2005 as a whole was \$ 53.7 billion and foreign direct

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38) Denaeva, E. [2004] "Economic Cooperation between the Russian Far East and Northeast Asia: Present State, Problems and Prospects", p. 85, *Far Eastern Affairs*, Vol. 32 No. 1.

39) *China Statistic Yearbook* [2006].

investment in Russia in 2005 was \$ 13.1 billion. Chinese investment in Russia was less than 1 per cent of Russia's capital inflow<sup>40)</sup>. The small amount of Chinese investments are due to the facts that (1) China has just started to invest in foreign countries, (2) Chinese investors are only marginally interested in the Russian market, and (3) For the Chinese, Russia remains a risky and low-profit market in terms of investment and technological policy<sup>41)</sup>. Chinese investment is concentrated in Khabarovsk Krai and Primorsky Krai.

The size of the authorized funds in these enterprises was extremely small. On the average level, the scale of Chinese investment in the RFE is around \$ 40-80 thousand. Comparing with the average level of Chinese overseas investment, which is \$ 1 million, and the average level of Chinese foreign investment in Russia, which is \$ 100 thousand, the scale of Chinese venture in the RFE is very small<sup>42)</sup>.

In order to step up and expand the scale of investment collaboration, an agreement was reached in May 2002 on creating an intergovernmental Standing Working Group on Investment. It was decided that several pilot investment projects would be chosen and given whatever help and support they need. In April, 2004, during the 9th regular China-Russia Prime Ministers' Meeting between Premier Wen Jiabao and Russian Prime Minister Mikhail Fradkov, Wen announced that China would invest up to \$ 12 billion in Russia through 2020.

Bilateral investment cooperation has been booming. In 2005, Russia and China signed investment agreements totaling more than \$ 2 billion. Russia and China have signed many investment agreements on several occasions such as

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40) The major nations investing in Russia are Cyprus, Luxemburg, the Netherlands, Germany, Britain, the United States, and France. They account for nearly 82 per cent of cumulative foreign investments.

41) Livishin [2006] p. 11.

42) Li Chuanxun [2005] "Economic Co-operation between Chinese Northeast and Russian Far East", p. 5, *Cross-Border Labor Migration and Regional Economic Development in North East Asia*, Edited by S. Ohtsu, 2005 Minerva Publishing House.

international trade and economics fair in Harbin, the Second Russian-Chinese investment forum in St. Petersburg and SCO summit in Shanghai in 2006. Also the two countries signed an intergovernmental agreement to promote and to protect investment during the 11th regular China-Russia Prime Ministers' Meeting. More agreements were also signed at Sino-Russian Investment Promotion Week and the third China-Russia Conference on Investment Promotion held in Beijing. This event is organized by China's National Development and Reform Commission (NDRC) and Russia's Economic Development and Trade Ministry<sup>43)</sup>.

In order to meet surging domestic demands, China has been eager to increase its investments in oil production and natural resources extraction abroad including in Russia. However, Chinese resource-seeking investment initiatives did not get along well in Russia. Actually, Russian authorities are reluctant to permit the Chinese companies's access to significant upstream assets.

For instance, in 2002, China's main state oil producer China National Petroleum Corporation (CNPC) showed its intention to tend a bid on the Russian government's 74.95 per cent stake in Slavneft, one of Russia's largest oil producers, however because Russian politicians expressed concerns that Russia should not allow important state assets to fall into foreign hands, CNPC had to withdraw its application to bid<sup>44)</sup>.

In the case of Udokan copper, it is still not clear that Chalco (Aluminum Corp. of China), China's largest aluminium producer, can participate in exploration or not. Chalco's intention to bid in the Udokan copper deposit which is located in Chita Region on the Russian border with China, crashed. Udokan, which has been the focus of Russian, Chinese and international mining interest for a decade, is believed to contain 27 million tons of copper. As Udokan is classified as one of

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43) China Daily, November 10, 2006.

44) New York Times, December 18, 2002.

Russia's strategic deposits it may only be developed by a Russian company or by a joint venture, in which the Russian partner holds 51 per cent. And Russia's new subsoil law bars foreign investors from "strategic" mineral deposits. Chalco tried to take half of a consortium planning to bid for the state-owned deposit with Urals Mining and Metals, but did not succeed<sup>45)</sup>.

The Sino-Russian forestry would-be joint ventures in the Far East and Siberia have met difficulties too. In 2000 Russia and China signed a framework agreement on forestry cooperation, in April 2006 the Russian Federal Forestry Agency (Rosleskhoz) delegation traveled to China to discuss joint projects. Russia and China discussed a long-term lease of one million hectares of Siberian forests as "a pilot project on joint use of forest resources". Although one million hectares of forest represents a mere 0.2 per cent of Russia's total forested area, the idea immediately sparked harsh criticism. Environmentalists decried the idea as an ominous sign for Russia's taiga forests. The local politician and media showed their concerns against Chinese migration. ANN news agency quoted Yuri Shvytkin, a legislator from the Krasnoyarsk regional assembly, as commenting that Siberian regions should employ Russian citizens, as now the Chinese appear to be infiltrating Siberia, and it would be difficult to drive them back home<sup>46)</sup>. Komsomolskaya Pravda commented that "the project is set to become a no-win situation for Russia, as there is hardly any point in swapping our pristine taiga for paper dollars or yuans, the would-be joint venture is almost certain to employ Chinese nationals, who are very unlikely to leave Siberia voluntarily, even after the expiration of the forest lease"<sup>47)</sup>. The fear about "the Chinese are coming" will be discussed in another paper; nonetheless, if it is not outright hostile, it is absolutely "China unfriendly".

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45) The St. Petersburg Times, June 27, 2006.

46) Asian News Network, July 27, 2006.

47) Komsomolskaya Pravda, July 28, 2006.

The Russian government is trying to get all the “strategic resources” under its controls. The Russian economics minister announced that the government will restrict foreign companies’ access to 39 strategic economic sectors, including weapons production, the nuclear industry and mineral deposits<sup>48)</sup>. According to the results of a poll by the All-Russia Center for the Study of Public Opinion, the majority of Russians are dead set against foreign capital’s participation in the military-industrial complex (80 per cent of the respondents), oil and gas sector, power industry, and forestry (66 per cent to 69 per cent).

One Chinese expert on Russia Wang warned the Chinese government to be cautious with increasing its investment in Russia. He wrote “Premier Wen’s announcement of \$ 12 billion investment in Russia through 2020 was not well understood in Russia. The Russians do not understand Chinese’s sincerity and intention; they think that the Chinese are only interested in Russia’s resources and energy”<sup>49)</sup>.

#### **4 Energy Cooperation**

One area of economic cooperation between Russia and China that seems to hold great promise lies in the energy sector. In the last 10 years, Russia’s oil and gas companies have been seeking outlets for these commodities not only in the West, but in the East as well. The prospects for the development of close economic ties (and subsequent stability in the overall relationship) through trade of gas and oil appears to be quite high.

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48) RIA Novosti, March 2, 2006.

49) Wang Xianju [2005] “Increasing Mutual Understanding and Improving Mutual Trust”, p. 75, *Russia, Central Asian & East Europe Studies* (in Chinese), 2005 No. 1.

#### 4.1 Oil and pipeline

Russian oil supplies to China have long been seen as a key element of bilateral trade ties. In 2004, Russia provided China 12 million tons oil and oil products, which is nearly 10 per cent of China's imports, making Russia China's fifth-largest foreign oil supplier. We will take an overview of Sino-Russia's cooperation in the energy field.

Since 1993, with rapid growth of Chinese economy, China's oil consumption has been increasing constantly by 4.9 per cent on an average, becoming the fastest increasing rate of all countries. Also in that year, China moved from a net oil-export country to a net oil-import country. It is projected that China will need to import some 60 per cent of its oil and at least 30 per cent of its natural gas by 2020. The Middle East's share of China's imports was 56 per cent in 2001 and could increase to around 80 per cent by 2010. China's dependence on the Middle East and the sea-lanes stretching from the Persian Gulf to the South China Sea became a matter of great concern to the Chinese government. In order to diversify China's import channels and minimize the vulnerability of its oil supply, the Chinese government's keen interest in the development of Central Asian and Russian oil reserves and the construction of pipelines for oil transportation<sup>50)</sup>.

While China is working hard on diversifying its energy sources, Russia is trying to diversify its oil and gas export. Some 90 per cent of Russia's energy exports are to Europe, with most of the remainder going to countries within the former Soviet Union; only 3 per cent goes to East Asian countries. The high world oil and gas prices have translated Russia into an "energy superpower" and it has taken a much more vigorous approach towards diversifying markets and pipeline routes. Russia's National Energy Strategy envisages that by 2020 the share of total oil

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50) Downs, Erica Strecker [2000] *China's Quest for Energy Security*, Rand MR-1244-AF, Rand Cooperation.

exports to Asia will rise to 30 per cent (gas exports up to 15 per cent) from the current 3 per cent, and it anticipates that China will account for by far the largest proportion of this.

The export of Russian crude oil to China was started in 1995 by Yukos Oil Company (headed by Mikhail Khodorkovsky) through East Siberian Railway in small quantities. There are two routes for oil transportation. One is crossing at Zabaykalsk-Manzhouli, while the other is through Naushki at the Russian-Mongolian border. The railway transportation capability is limited and rail freight is expensive. High costs and low profit margins affected the economic viability of Russian crude oil exports to China<sup>51</sup>.

To facilitate the oil transportation, as early as November 1994, Russia suggested building an oil pipeline to China from Angarsk to Daqing, China. After nearly one decade of negotiations, and after many promises and agreements both on the government-level and company-level, on a trip to Beijing in September, 2003, Russian Prime Minister Kasyanov stunned his Chinese hosts by announcing that Moscow had decided to postpone an agreement on the Chinese route<sup>52</sup>. Then the Angarsk-Daqing pipeline was foiled by the arrest of Mikhail Khodorkovsky in October 2003<sup>53</sup>.

Since 2003, the Russian government was also reportedly leaning strongly

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51) Russian regulators have moved to make rail freight more competitive. Since the beginning of 2006, Russian Railways (RZD) cut its freight tariffs for China-bound oil by some 17 per cent. Nonetheless, the tariffs remain high, \$ 59 per ton for Zabaykalsk and \$ 39 per ton for Naushki. RZD has indicated readiness to discuss \$ 28 per ton tariff as soon as supplies reach 40 million tons per year. Blagov, Sergei [2006], "Russia Ups Oil Exports to China by Rail", *Eurasia Daily Monitor*, Volume 3, Issue 144 (July 26, 2006).

52) For the details of the pipeline, see Lo [2006].

53) Within six months of taking office as Russia's new president, Vladimir Putin was by the summer of 2000 already moving hard against the capitalist-inspired oligarchs who were fleecing Russia of its natural resources and industry with, at a bare minimum, the full complicity of the West. Stroupe, W Joseph [2006] "Russia tips the balance", *Asian Times*, November 23, 2006.

toward the Angarsk-Nakhodka route which was proposed by Japan and Russian state company Transneft. Even the Russia foreign relations experts are divided on the pipeline issue. In a situation analysis conducted by the Russian Council on Foreign and Defense Policy and the Institute on Foreign and Defense Policy, “The panel of experts concluded that – from the political point of view – the best solution would be the construction of a single pipeline from Angarsk, which would then fork toward the Russian port of Nakhodka and China’s Daqing. Another possibility involves building two separate pipelines to those destinations. The experts argue, however, that Russia does not yet have enough oil for these pipelines to operate at full capacity”. “Several experts argued that a decision not to build an oil pipeline to Daqing would seriously undermine Beijing’s trust in Moscow. It would strengthen suspicions that Russia’s Chinese policy is being led by Washington and Tokyo which, it is believed, seek to weaken the Chinese economy and keep China dependent on Middle Eastern oil”, “The panel failed to reach a consensus as to which route is more preferable. Most of them gave preference to the Angarsk-Nakhodka route. An overwhelming majority of the experts concluded that the choice of this route is more probable for political reasons. At the same time, they said it would be unwise to rule out the construction of a pipeline to Daqing”<sup>54)</sup>.

However, in December 2004, Russia finally made its choice to build the Nakhodka route. At the same time, Russia tried to alleviate the damage to China by pledging to increase its total oil deliveries to China by rail to 11 million tons in 2005, from 6 million tons in 2004. At the summit meeting in Moscow, state oil firm Rosneft signed cooperation deals with the Chinese oil firm Chinese National Petroleum Corporation and Asia’s biggest refiner, Sinopec<sup>55)</sup>.

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54) Bordachev, Timofei [2004] “China Today: Challenge or Opportunity?” pp. 133-134, *Russia in Global Affairs*, Vol. 2 No. 2.

55) Blagov Sergei [2005], “China knocking on Russia’s door”, *Asian Times*, July 6, 2005.

On December 31<sup>st</sup>, 2005, Prime Minister Mikhail Fradkov signed the construction plan for the “Pacific Route” of the oil pipeline<sup>56</sup>). The main body in charge of construction will be Transneft, the state-owned pipeline construction company. According to Lo Bobo, “The decision to build which pipeline fundamentally affected the direction of Russia’s oil and gas cooperation with its Asian neighboring countries. Moscow’s decision to renege on an agreement to build the East Siberian oil pipeline to Daqing in Manchuria arose mainly out of concern that Russia would open itself up to possible blackmail from China as the monopoly customer. In opting for the much longer and more expensive route to the Russian Pacific port of Perevoznaya, Moscow hopes to reduce its dependence on Beijing by diversifying exports to the wider Asia-Pacific market such as Japan, South Korea, the United States, and Southeast Asia. Achieving such an outcome would enable Moscow to dictate the terms and conditions of delivery, and exploit energy more effectively as an instrument of geopolitical influence in the Asia Pacific Region”<sup>57</sup>).

It is not clear what happened in Moscow, the east-bound pipeline took a new turn. The Russian government subsequently decided that, while the Siberian-Pacific pipeline project itself would be maintained for reasons of “national interest,” the initial construction would start with the Taishet-to-Skovorodino portion, from which a connecting pipeline would be built by the Chinese to reach Daqing. It was also agreed that, pending the construction of the pipeline, China would receive a substantial amount of oil by rail.

While Russia has been ambiguous about its energy cooperation with China, Kazakhstan has given China a great welcome. As Kazakhstan currently exports 70

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56) The pipeline will run about 4,400 km from Taishet in Eastern Siberia to Perevoznaya Bay in Primorskiy Krai and have a maximum annual transport capacity of 80 million tons.

57) Lo [2005] pp. 5 - 6.

per cent of its oil via pipelines passing through Russia, it is anxious to develop new markets. The Chinese National Petroleum Company has invested \$ 700 million in oil development. In December 2005, Kazakhstan inaugurated the 1,000-kilometer Atasu-Alashankou oil pipeline to export crude oil to China. The \$ 700 million pipeline is expected to pump 10 million tons per year. According to Xia Yishan, head of China's Energy Strategy Research Institute, only one-half of the initial 10 million tons of crude oil per year would be supplied by Kazakhstan, while the other half would come from Russia<sup>58)</sup>.

Chinese media reported that first Kazakh oil arrived at Alashankou in Xinjiang on April 30, 2006. The Atasu-Alashankou pipeline has given the Central Asia states new opportunities for energy cooperation with China. Meanwhile, early oil supplies from Kazakhstan seemingly hastened the construction of the Russian Taishet-Nakhodka pipeline<sup>59)</sup>.

#### 4.2 Gas

The initial focus of Russian-Chinese energy discussions in the 1990s was on the Russian supply of natural gas to China and the construction of a gas pipeline. China and Russia signed an agreement for the gas exploration in the Kovytkinskoe and the construction of a pipeline to China in June 1997. Later, the Kovytkinskoe gas project was stalled for a variety of reasons<sup>60)</sup>.

By the early 2000s, Russia had proposed a variety of initiatives to China involving collaborative efforts in gas fields in Siberia and the RFE. This included

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58) However, it would need Russian crude oil from Western Siberia coming via the Omsk-Pavlodar-Shymkent pipeline to reach its full capacity of 20 million tons by 2010. Now Transneft appears to be planning to use the Atasu-Alashankou and Omsk-Pavlodar-Shymkent pipelines to export crude to China (People's Daily, April 28, 2006).

59) People's Daily, April 28, 2006.

60) Wilson [2004] p. 86.

the development of gas fields in Yakutia, with the construction of a gas pipeline stretching to China; various proposals to construct gas pipelines to connect China to the Sakhalin gas and oil fields; and the shipment of liquefied natural gas from Sakhalin. So far, none of the long envisioned bilateral energy-infrastructure projects has been achieved. However, the situation has apparently changed recently.

Gazprom, the Russian biggest state gas company, signed a memorandum on gas supplies with the CNPC, during President Vladimir Putin's 2006 March visit to China. On October 18, 2006, Gazprom CEO Alexei Miller and CNPC President Chen Geng discussed the main conditions for supplies of Russian gas to China through pipelines running from western and eastern Siberia, according to a Gazprom press statement. On October 17, 2006, Gazprom began construction of the West Siberia-China pipeline in Altai region. The pipeline link is part of an \$ 11 billion Gazprom program involving two gas pipelines supplying China with 80 billion cubic meters (bcm) of natural gas annually. A western pipeline, linking the western Siberian gas reserves to the Xinjiang region, where it will link up with China's west-east pipeline, will cover 2,800-kilometers and has a designed production capacity of 30 bcm per year.

Aside from preparing to build the Altai gas pipeline from Western Siberia, Russian authorities have also indicated plans to build a new gas pipeline from Sakhalin to neighboring China along a network of gas pipelines to supply domestic consumers (Sakhalin-Komsomolsk-on-Amur-Khabarovsk domestic pipeline) in RFE<sup>61</sup>). The proposed Okha-Komsomolsk-on-Amur-Khabarovsk-China export pipeline, running from the island of Sakhalin off Russia's Pacific coast via the Russian mainland to China, would have a projected capacity of 8 bcm per year<sup>62</sup>).

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61) Blagov, Sergei [2006] "Russia Eyes yet another Gas Pipeline to China, *Eurasia Daily Monitor*, Volume 3, Issue 158 (August 15, 2006).

China has very little domestic gas reserves but a seemingly insatiable growing demand for more environment-friendly energy resources; this is one of the factors that compelled it toward the establishment of partnerships with Russia, the world's largest depository of natural gas. All this indicates bright prospects for the future. But one can never be assured that all promised gas pipelines will be realized. In the Russian energy sector, as part of a recentralizing move, Gazprom was promoted to be the dominant gas producer and gas exporter. But in the monopoly environment and under strong state protection, Gazprom did not invest enough to increase the gas production even at the time that Gazprom's mature gas fields' production is continuing to rapidly decline. There is no guarantee that there will be enough gas to be exported to China; the Altai Pipeline will be laid actually, Furthermore, will the Altai pipeline have the capacity to ensure gas supplies to China in preliminarily agreed volumes? Can China and Russia agree on the gas price this time?

Meanwhile, in order to avoid an over-reliance on China, Russia seems keen to develop broad discussions on energy issues not only with China, but with other major Asian players as well<sup>63</sup>). Comparing with the indecision and contradictions regarding the pipeline to China, Russia made quick decisions for oil and gas business with other countries such as Japan and Britain in the development of Sakhalin. All this led the Chinese to reflect about its energy cooperation with Russia. As a Chinese scholar wrote, "Why didn't the Russian media write about the Sakhalin oil and gas deal with Western states including Japan as exploitation of Russia's natural resources, and why do Russians view the oil export to China as

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62) RIA-Novosti, August 2, 2006.

63) According to Foreign Minister Sergei Lavrov, the Russian Foreign Ministry hopes "to start energy dialogue with China, India, Japan, and Korea in the future." According to Lavrov, Moscow believes there are enormous opportunities for foreign investors in the construction and modernization of energy facilities (RIA-Novosti, June 18, 2005).

becoming China's 'energy and raw materials vassal state'?'<sup>64</sup>).

In conclusion, there are chances for the energy co-operation, but there are also tensions. China is frustrated about the slow paces of deals. One can not be too optimistic about it.

### 4.3 Electricity

Russia's energy cooperation with China is not limited to oil and gas. In the past five years, natural gas and electricity cooperation between Russia and China has also increased.

In the mid-1990s, Russia and China discussed a project to build a \$ 1.5 billion 2,600-kilometer-long power transmission line from Irkutsk region in Siberia to China. This time, because that the two sides never agreed on electricity prices, the plan was abandoned in 1999. In the Chinese view, Russian prices were too high to warrant investment. Like other cooperative efforts in the energy sector, various projects to export Russian electricity to China were deterred by the lack of financial resources.

However, the situation has apparently improved recently.

China started to import electricity from Russia<sup>65</sup>. In 2004, China and Russia signed a contract that till 2013 China is going to import electricity from Russia, annually from 1 billion to 2 billion kilowatt-hours (kWh)<sup>66</sup>. Electricity supplies to China reached 300 million kWh in 2004, 500 million kWh in 2005. Russia plans to supply 800 million kWh in 2006<sup>67</sup>.

On July 1, 2005, Russia State United Energy System and the Chinese State

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64) Wang [2005] p. 76.

65) In 1992, China imported 100 million kWh electricity from Russia Far East.

66) Nihon Keizai Shimbun May 27, 2004.

67) Blagov, Sergei [2006] "China Eyes Russia, Central Asian States as Sources of Cheap Electricity", *Eurasia Daily Monitor*, Vol. 3, Issue 123 (June 26, 2006).

Power Grid Corporation signed an agreement on cooperation that would enable the large-scale export of Russian power to China. During Putin's visit to China in March 2006, an agreement to carry out a feasibility study for energy supplies to China was signed. In the agreement, the electricity cooperation will be developed in three phases, in the first phase, the goal is to expand the border regions' power transmission. From 2008, electricity will be transmitted from the RFE to Heilongjiang province, to 3.6-4.3 billion kWh per year. In the second phase, from 2010, electricity will be transmitted from RFE to Liaoning Province electricity grid to 16.5-18 billion kWh per year, in the third phase, from 2015, electricity will be transmitted from RFE to Northeast China and North China to 30 billion kWh per year<sup>68)</sup>.

Chinese firms have also pledged to invest in the power transmission infrastructure. Xinhe, a company based in border town of Heihe, has indicated plans to invest the equivalent of \$12 million to build a power transmission line across the Amur River in order to prepare for large-scale sales of Russian electricity to China<sup>69)</sup>.

In the nuclear power area, slow but steady progress was made, and there is a huge potential for Sino-Russian cooperation too. In the nuclear area, Russians' needs, interests, and anticipations are very strong and passionate. The Tianwan nuclear power plant, a major Sino-Russian project now under construction in Lianyungang, a port city in East China's Jiangsu Province, is an example of collaboration in the use of nuclear power for peaceful purposes<sup>70)</sup>. This project

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68) Lu Nanquan [2006] "An Analysis about the Sino-Russian Economic Co-operation", p. 5, *Russia, Central Asian & East Europe Markets* (in Chinese), 2006 No. 7.

69) Interfax, June 20, 2006.

70) Jiangsu media reported that the first unit of the plant started generating electricity last month; while Russian media said it would reach full capacity next month (China Daily, November 10, 2006).

started from December 1997, it was reported that the capital outlay is about \$ 2.5 billion and Russian involvement with this project would provide work for 700 Russian factories and job opportunities for 220,000 workers over a three-year term. Russians see this cooperation as test case for Russia not only the future development for Russian-Chinese nuclear initiatives but also the ability of the Russian nuclear industry to perform as an international player<sup>71</sup>). China intends to obtain technologies for the production and assembly of reactor equipment in its next round of construction of nuclear power plants. The Russian side tentatively agreed to provide the technologies if it would be contracted to build another four units in Tianwan in the future<sup>72</sup>).

It is reported that in the next 15 years, China will need at least 30 nuclear power plants. Now Russian companies are bidding for 4 nuclear reactors, competing with Westinghouse Electric Company and French Areva T&D company<sup>73</sup>). On the first day of Putin's visit to China in March 2006, he made it clear that "cooperation between Russia and China in the energy sector includes continuation of our involvement in the construction of new nuclear facilities in China [emphasis added]." Yet, until at least one of the two Russian-built reactors in Tianwan becomes fully operational at the end of 2006, China may not contract for additional Russian reactors. "Should the first two reactors [be] successfully commissioned, Russia has the rights [emphasis added] to obtain a contract on constructing a third, fourth, and maybe other reactors," claimed Russian Federal Atomic Energy Agency (Rosatom) Sergei Kiriyyenko in Beijing<sup>74</sup>).

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71) Wilson [2004] p. 79.

72) Yu Bin [2004] "China-Russia Relations: Living with Normalcy", p.143, *Comparative Connections*, Vol. 5 No. 4.

73) Lu [2006] p. 5.

74) Yu [2006] p. 151.

## 5 Concluding Remarks

The principal focus of this paper was to examine the economic cooperation between Russia and China. On the one hand, economic cooperation has become an important leg of the Sino-Russian partnership. China and Russia have become each other's major trading partner. Both governments are trying to bring the economic relationship to a higher level. On the other hand, there are also problems. First, the illegal aspects of trade practices need to be addressed. Second, comparing with their trade relationships, the investment link remains very weak. Third, due to the weakness of both countries' private companies, the intergovernmental relationship is crucial to maximizing the potential of long-term energy and infrastructural projects, and the same can be said with such traditional spheres as arms sales.

Another focus of this paper was about the prospects of the bilateral economic relationships. The complementary economies of both countries provide great potentials for trade, investment and energy cooperation, however, despite some positive trends mentioned above, it remains unclear whether Russia and China are able to realize the potentials. The concern is that mutual mistrust will be a stumbling block for future development. In this connection, policy-makers in Moscow face an interesting dilemma. On the one hand, Russia has an obvious interest in sustaining economic growth by taking advantage of its strengths – oil and gas exports, to China, arms transfers to China; and tapping lucratively into the growing demand for nuclear energy. On the other hand, Russians have had many apprehensions regarding China. Oil and gas exports to China help drive the furious pace of modernization, a modernization fundamental to its transformation into a global power. The expanding Chinese economic power could be a concern in the long term. Similarly, the transfer of arms and weapons technology enhances Chinese military capabilities, which could one day be used against Russia.

China's appetites for Russian raw materials have made Russian leaders less comfortable than they thought. Russia must undergo a steep learning curve to adjust to the growing power of China and forgo the leadership position it historically has occupied.

On the Chinese side, the twists and turns in the Angarsk-Daqing pipeline gave the Chinese enough reasons to believe that "Russians can not be trusted". And the Chinese has learned that the Russia-China "strategic relationship" will not go anywhere without coinciding with Russia's national interests.

The debate on Sino-Russian economic relations in both countries should be encouraged, involving the academic community in both countries and NGOs. Moscow and Beijing should reach out to the Russian people as well as the business communities in both countries that the realization of mutual interests in the future depends on mutual trust. Mutual distrust could threaten economic cooperation between the two countries.