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**Re-Orientation: Russia Looks East**

In 1869 the U.S. completed the transcontinental railroad. With shipping interest in the Atlantic and Pacific Oceans, the partners of Brown Brothers, one of the key investment banks of the period, understood the golden spike as linking Europe and Asia. A little more than a century later, the center of gravity in the world economy has shifted. Since the early 1980s, trade over the Pacific has exceeded that over the Atlantic.

Now a new and profound re-orientation appears to be taking place. Traditionally, Russia looks westward to Europe for its energy exports, but now it is making important strides toward diversifying to the energy-thirsty Northeast Asia (China, Japan, South Korea, and Taiwan), which consumes as much, if not more, energy than the United States and Europe. In contrast to Northeast Asia, the traditional European market is sclerotic and officials are debating significant cuts in fossil fuel consumption over the next decade.

**Pipelines**

Transneft, Russia's state-controlled pipeline company, has built a pipeline from the East Siberian oil fields in Taishet and Talakan to Skovorodino. The three-year and 1,700 mile long construction project was finished last year. Russia also completed modernizing port facilities in Kozmino and intends to build a pipeline from Skovorodino to Kozmino in the coming years, but in the meantime, will use rail to move the oil.

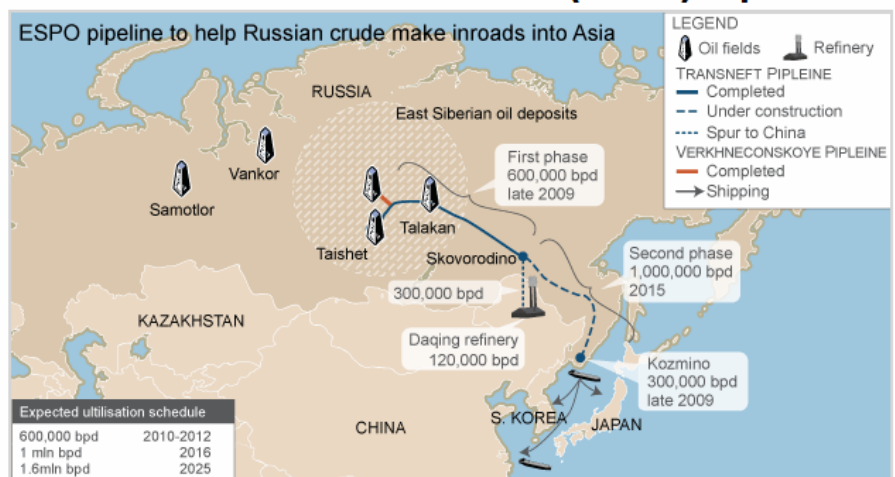
When the entire project, called the East Siberian-Pacific Ocean, or ESPO, pipeline is complete, it will be longer than the distance from New York to Los Angeles. While the collapse of the oil prices in mid-2008 threatened to delay construction, a deal struck with China in April of 2009 breathed fresh life into the project.

In April of 2009, state-owned China National Petroleum Company agreed to lend Russia's Transneft and Rosneft \$25 billion in exchange for building a trunk line from Skovorodino to the Chinese border roughly 40 miles south and guarantee supply of 300k barrels of oil per day for the next 20 years. China will build a 500 mile pipeline on its side of the border to its oil, gas, and refinery assets in Daqing. When the project is complete and integrated with the modern terminal and port facilities in Kozmino, which can accommodate those huge oil tankers, Russia could supply oil to Korea and Japan as well as China. The same general story holds for natural gas. The year-old facility in Sakhalin is operating at a third of its capacity and exporting 2/3 of the liquefied natural gas (LNG) to Japan as well as some to South Korea.

**New Competition**

The oil that will be carried by the ESPO pipeline is rather interesting itself, which may have a potentially significant impact. It is still early in the process, but the oil is reportedly of a higher quality than the Urals blend, apparently diesel rich and medium heavy sweet. The ESPO blend appears to be a particularly good fit for the refineries in China and Japan. Moreover, this type of oil is not readily available in the spot market. In June of 2009, Russia eliminated the excise tax on East Siberian oil

As the world's largest oil producer, 10.02 million barrels per day in November of 2009, and with a 2.6% increase year-over-year, is aiming reach 11 million barrels a day in 2010, Russia is competing with OPEC and this new blend opens another front in that competition. Industry experts opine that the ESPO blend competes most closely with Oman's oil and some suggest that it may even impact Saudi Arabia's light crude. OPEC may counter with a new blend.

**East Siberian - Pacific Ocean (ESPO) Pipeline**

If the ESPO blend impacts OPEC, the Sino-Russian economic operation impacts the U.S. ability to project power in the region. The U.S. has failed to build upon the cooperation and good will of several Central Asian states (think the 'stans) in the war against terror in Afghanistan in 2002. Additionally, the U.S. has suffered several setbacks, including the loss of bases in the region.

The Chinese-Russian agreement is both a reflection and extension of, the Central Asia's reorientation eastward, at the increasing exclusion of the United States. At the same time, the economic cooperation between China and Russia is unlikely to prevent continued rivalry for influence in the region. Many of these newly independent countries will jealously protect their sovereignty, and seeking to offset the influence of China and Russia, may open unforeseeable opportunities for the U.S.

### **Risks**

If the general argument sketched above is fair, the re-orientation has just begun and there are still a number of risks. Construction could be slow and such projects are often perceived to be fraught with fraud and corruption. They tend to take longer and cost most than initially anticipated.

There are numerous environmental concerns, including the proximity of the ESPO pipeline to Lake Baikal, the world's largest fresh water lake. Some observers have also expressed concern about the potential for earthquakes in the region.

The new grade of oil is still somewhat uncertain and the quality parameters do not appear to have been fully determined. Russia also reportedly has its own way of doing business, which is different than what is customary in Asia.

More important, from a financial point of view, the relationship between the state and state businesses is ambiguous as the recent experience of Dubai World, Fannie Mae, and Freddie Mac, illustrate. This raises legal questions for investors in parts of the world for which property rights have yet to fully congeal.

### **Novus Ordo**

The rise of China, and the industrialization and modernization of East Asia in general, is part of the re-orientation of the global economy. Europe seems to be the primary loser in this process. After all, the U.S. is as much a Pacific as Atlantic power and its share of the world GDP has remained relatively steady over the past few decades.

The biggest threat to open maritime commercial regimes, like Pax Americana and Pax Britannia before it, are more closed, land-based regimes which are typically less trade oriented, or more mercantilist (and typically more egalitarian). It is the parameter against the heartland; it is the successors of Athens clashing with the heirs of Sparta. The re-orientation of central Asia, including Russia, could pose such a geostrategic threat in the future.

More immediately, the investment opportunities may require higher levels of anticipated returns to compensate for the risks posed by lack of transparency and clear rule of law. On a macro-level, the currencies, bonds, and equity markets of Russia and China are unlikely to be influenced from these factors, even if there are individual company level or sector opportunities.

While investors and speculators in American railroads, one of the wild emerging stock markets for much of the 19<sup>th</sup> century, struggled to make money, the golden spike created unimaginable opportunities and forever changed the American landscape and social fabric. So too does the re-orientation of central Asia, particularly Russia, toward Northeast Asia represent a potentially significant shift in the contours of the world economy, unleashing new forces of creative destruction.

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