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# Restructuring and Competition in the Car Industry in Russia: Conglomerate Control vs. Cooperation with Foreign Firms[1]

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**Abstract**

This paper presents the state of industrial restructuring of the car industry in Russia and analyses the strategy of the main actors in the sector. The three main ones being; Russian industrial groups, foreign multinational corporations willing to enter into the market, and thirdly, the Russian government which has to decide between supporting its national industry and, or, opening the market to world competitors. In other transition economies, foreign direct investments have played a major role in controlling this strategic sector. This took the form of acquisition or greenfield investments; FDI forcing local governments to

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implement the rule of law and clear property rights. On the contrary, in Russia the transformation of the car industry is following another path. FDI cannot take strategic stakes in the car industry while the government and carmakers have an ambivalent position concerning the presence of foreign companies. On the one hand, the presence of FDI could help to restructure and to fill the technological gap. On the other hand, the shock of industrial restructuring and its social, economic and regional issues could be damaging, leaving aside the question of the control of strategic assets. Recently, big financial and industrial conglomerates have started to move in this sector and started restructuring. This left foreign competitors on the edge of the market with a limited choice of action; either to cooperate on some segments of production, or start greenfield investments, this in a difficult environment where almost everything had to be built from scrape.

KEYWORDS: Transition, car industry, restructuring, competition, industrial cooperation, vertical integration, and foreign direct investment

JEL classification: D2, F2, L2, M2, P2

## Introduction

Industrial restructuring in transition economies is probably one of the most difficult task. It has to be carried out by new entrepreneurs, the emerging financial sector, the government of these countries and possibly foreign investors attracted by potential growth of industry and services in the region. Restructuring deals with many assets; organization changes, change of output set, investments in new plants and machinery, as well as the development of new networks for supplying and marketing purposes. Even in mature market economies restructuring is not always a *sui generis* process. This is very obvious when looking at mergers and acquisitions, or brutal split of activities. These illustrate how big groups (megalomanias purposes kept aside) concerned by the decline in their profitability reallocate their capital by disbanding assets, aggregating others, rationalizing production or other segments, in order to either to attain an efficiency size, buy market shares or built up strategic positions [Batsch, 2000]. In transforming economies, the process of industrial restructuring has been difficult to fulfill for different reasons. The three main reasons are; systemic heritage from the former soviet industrial system, political and social barriers, and lack of capital and managerial know-how to be able to put these firms at the level of Western industrial standards.

In most advanced transforming economies of Central European Economies (CEEEs)[2], privatizations and opening-up policies have created a new economic environment. In turn this has facilitated the inflow of foreign direct investments, which have played a major role either in taking over existing firms, or in building up new greenfield investments [Transnational corporations, 2001]. The presence of foreign capital, added to the commitment of investors and their willingness to develop new businesses, have pushed local governments to set up attractive policies in order to retain investments. This was done by deepening legal procedures, establishing the rule of the law and removing entry barriers. As a result, among countries that have followed this path, massive foreign investments have contributed to restructure local businesses, develop new ones and generally have created positive externalities (export increase, job creation in other sectors). On the opposite, domestic firms, especially the ones considered as strategic were taken over by foreign firms and integrated into their global or regional strategy.

The picture is quite different in CIS countries, first of all in Russia. Firstly, in spite of mass privatization and the development of market relations, the enforcement of property right remains fuzzy. Secondly, strong barriers to restructuring have delayed the process of adjustment and kept away foreign investors. And thirdly, big financial-industrial groups have advocated and lobbied for conservative measures, collusion of different interest groups [Maroudas and Rizopoulos, in this issue] has prevented the unbundling of assets. Considered in the framework of a ‘virtual economy’, in spite of noticeable progress, restructuring has made little progress, especially in the car industry.

In this paper, we analyze the restructuring of a major industry in Russia, the car industry. For this, will be studied the involvement of a set of actors directly concerned by its modernization:

- the owners of car companies
- the government
- foreign car makers eager to enter the market
- consumers (domestic and exports).

We will assume that, as in other post-socialist economies, the car industry cannot restructure itself without the cooperation of foreign companies bringing in capital and missing competencies allowing the up-grade of the industry

[2] *All former socialist economies except CIS countries*

(management, technology, suppliers, etc.;). We will also assume that foreign companies, according to the level of risks and the property right regimes, either; absorb, turn around and integrate local companies in their world or regional strategy and networks; cooperate on some segments of production, setting joint-ventures, without participating in the operation of the rest of domestic companies (GM-AvtoVAZ,); or directly set up greenfield investments without cooperating with other domestic car plants (Ford, Renault-Avtoframos). In all cases, their involvement on this market doesn't contribute to the rapid creation of spin offs and positive externalities, as is generally the case in CEEEs countries [De Sousa and Richet, 2000]. This is mainly due to the high transaction costs involved in the setting up of suppliers and dealers' networks, the increase of product delivery, or the quality control.

We will here define also a set of parameters. Firstly, that car company shareholders in Russia have moved from rent-seeking strategies (digging the hole) to value-added strategies (expending the hole) in order to create more value launching both horizontal diversification and vertical integration strategies. Secondly, that the government has to fulfill different tasks: duties for protecting domestic car makers, some kind of horizontal and sectorial industrial policy to protect the main producers and allow them to rationalize their production by easing the access to R&D, credit, export facilities. And finally, that there is a direct link between economic growth, the growth of domestic purchasing power of Russian households and the demand for better cars. This, in a sector where demand plays a major role, even in the range of cars where Russian makers are still leaders.

The remainder of this paper is divided in three parts. Section 2 analyses the causes of the institutional and administrative barriers attributable to the delay in restructuring Russian enterprises and the remaining of a soft budget constraint. Section 3 analyses the different entry mode of foreign companies and the trade off between cooperation and competition. Section 4 emphasizes the difficulties encountered in the set up of cooperation between firms, and analyses the role of the State in the modernization of the automobile industry.

**The roots of the low adjustment process in Russia**

Compared to CEEEs, the transformation of the industrial structure of the FSU economy has been more difficult to carry on, due to the long gap existing between the industrial organization of the socialist economy and a fully-fledged market economy. Furthermore, this was made more difficult because of the entrenchment of the socialist system and the powerful administrative mechanisms that allowed this economy to fulfill its planned targets. The differences between the two regimes were ones of space, allocation of natural resources, economic objectives and also openness. Russia didn't have to trade a lot, except in order to buy the technology that the country was not able to produce and was missing to built up its military power. In spite of statistics produced under the former system, which aimed at over-emphasize the role of the manufacturing sector (through the distorted price system), Russia is still today an extractive economy even if industry and service sectors are growing at a rapid pace. Nearly sixty percent of its exports revenues are still made from raw and energy goods.

Among the ten first Russian companies, eight produce gas and oil, one belongs to the heavy industry, another one to the car industry (AvtoVAZ). The under pricing of these natural goods on the domestic market and the opportunity to export them against high prices on market economies is the main source of income. It supports the existence of a soft budget constraint on companies and households and facilitates the concentration of assets in the Russian economy, especially among companies, which can rely on exportable goods in order to finance their acquisitions.

**Russia and the virtual economy**

Contrary to the other transition economies, in spite of the fact that almost all the production and services are made by private companies Russia is far from having adjusted and carried out the transformation of its industrial structure. One explanation of this can be found first in the asset specificity of the former soviet industrial organization, and, secondly, in the bias created by the Dutch disease effect. That is to say, relaying on the abundance of oil and gas, which revenues can finance the soft budget constraint and, in many areas, reduce incentives to restructure.

Gaddy and Ickes [2002] have coined the concept of 'virtual economy' to explain the functioning of the Russian economy and the behavior of economic agents: households, companies, government:

> *'The virtual economy is the outcome of agents' adapting their behavior to an environment that threatens their survival. It is characterized by a set of informal institutions that permits the production and exchange of goods that are value subtracting, that is, worth less that the value of the inputs used to produce them. Enterprises can continue such production because they have recipients who are willing to accept fictitious*

> *("virtual") pricing of the goods at levels that mask their unprofitability. Buyers and sellers collude to hide the fictitious nature of the pricing (...). In the classic form of the virtual economy, they do so by avoiding money: they use barter and other forms of non-monetary exchange… Since value is being destroyed as the system operates, there also has to be a source of value infusion. The ultimate "value pump" in Russia today is the fuel and energy sector above all one single company, Gazprom – Russia's natural gas monopoly. In exchange for the rights to keep what it earns from export, Gazprom pumps value into the system by supplying gas without being paid for it…. Gazprom subsidies – which then lead to arrears to the government – are the primary way in which unprofitable activity is supported today*. [Gaddy and Ickes 2002, p. 5-6]

This system can survive as long as many economic agents feel that it meets their need. It can also evolve – see the cyclical retreat of barter relations – but is hard to eradicate. What more, many firms are still engaged in barter relations, making it difficult for companies relying on monetary relations to expand[3]. As a consequence, incentives for restructuring are weak and companies can easily delay the modernization of their equipments and change their organization.

**Privatization and conglomeratization of the Russian industry**

The mode of privatization favored in Russia [Blasi *et alii*, 1996, Freeland 2000, Schleifer and Treisman, 2000, Hare and Murayev, 2002] has been radical, rapid, extensive and unprecedented in the world, creating two kinds of ownership. 90% of industrial output and 80% of industrial enterprises went to private hands. This mode of privatization, in almost one shot (in fact, two: in many firms the State has kept a minority control which has been sold latter, often at low price to shareholders who have been able to increase their power, often buying the share with the company's money) has not helped to restructure enterprises although there are some evidence of progress both in terms of investment, productivity across firms in the same sector. [Earle and Estrin, 2001].

Evolving in the virtual economy and beneficiating from the soft budget constrained most firms to delay their restructuring. Rent seeking was the first aim [Aslund, Boone, Johnson, 2001] and it took some time to understand that

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[3] *In fact, many companies can develop market relations and use cash, depending on the nature of the technology, of their product and the size of their market. A company producing final good, selling to households on a limited market, can more easily use cash for its transaction, for instance in the food industry (Interview with the director of the company Red October producing chocolate)*

asset striping didn't create value in the long run. The rule of law has been more formal than real and new shareowners have developed internal coalitions to protect themselves from threats (bankruptcy, liquidation, hostile take-over), especially where insider control was dominant. Former relations between enterprises or the relational capital of managers have contributed to develop the barter system even in sophisticated companies (aircraft industry). But, as Blasi *et alii* [1996] point out, in the mid 90s, according to the evaluation of the Russian National survey of corporations, no more than a quarter of Russian companies were clear winners (financially sound firms with well-established domestic or export markets). Among these firms, only a small number were able to finance their modernization out of their profit. According to their study, three-quarter of Russian corporations in 1996 were in need of radical and far-reaching restructuring. Furthermore, the nature of assets to be privatized as well as the distribution of ownership among insiders have made difficult a clear cut between what should have been liquidated and what should have been recapitalized.

The possibility to sell or to exchange shares has led to a continuous concentration of property "among the few" [Freeland, 2000] who were empowered with high relational capital, personal competencies, low adversity to risk and access to financing. Financial and industrial groups (FIG), also called Integrated business groups, which have been set up during the last decade, are a mix of the former industrial linkages among firms in the FSU, facilitated by strong relationships between politicians and industrialists (the 'relational capital', according to Gaddy and Ickes). This is an inevitable process, which has its origins in the Soviet era where enterprises where closely linked by strong bureaucratic structures. It is noticeable in the incapacity and unwillingness of managers of these big enterprises to adjust and split assets[4]. This is also emphasized by the fact that financial capital and institutions have operated in fragmented and imperfect markets. Investing and restructuring, thus, could be achieved by combining financial and industrial capital (Popova, 1999). These big enterprises possess common features: within each integrated business group, there exists a core group of manufacturing and banking enterprises surrounded by a wide web of financial institutions, building companies, transport companies, mass media outlets and even health and

[4] *For example, big car companies have to manage social assets (buildings for workers, health services) which are deterrent to the entry of foreign investors, not willing to control these assets. In depressed economic environment, these big enterprises are still considered as strong holds both by municipalities, provincial governors and have to perform social and public services. AvtoVAZ, for instance, still finance public services that the municipality where the company is located is unable to perform, such as paying policemen.*

recreation centers (Dynkin, 2002). They come out of the former centralized system, and, now look up at similar big enterprises in emerging markets (Brazil, South Korea), or to what existed in the US at the turn of the 1900s. What is interesting to observe, at this stage of development, is that frontiers of these conglomerates are very resilient. For the main oligopolies, consolidation in some businesses can go parallel with diversification strategies by selling out equities at a good price to enter new businesses with further growth prospects. Compartmentalization of different businesses under one share holding companies is a recent trend in the diversification strategy, associating banks which have to raise external funds to finance the acquisition [Aris, 2000]. But, as it can be understandable, merger of the new acquisition often cut short or is not on the agenda as companies in Russia are used to work with over capacities and that downsizing has not yet reached the business culture in this country.
At the present stage two interesting points have to be considered:

- an ever growing concentration of capital[5]
- a consolidation within and across industries

Concerning the first point, Boone and Rodionov (2002) point out that eight major shareholder groups – Menatep, Interros, Millhouse/Russian Aluminium, Sistema, LUKoil, Alfa, Surgutnefegaz and AvtoVAZ – had revenues of $ 62 billion in 2000, representing 50% more than the federal budget. By comparison, the largest state-controlled companies, Gazprom, Unified Energy Systems, Sberbank and Svyazinvest, had revenues of only $ 47 billion. Using their power and their political connections, theses groups have absorbed the coal industry, steel, car manufacturing, aluminum and now timber and the yet untapped agro industrial sector. As a result, the 8 groups control 85% of revenue from Russia's 64 biggest private companies.

Secondly, this process highlights a major change in the strategy of Russian firms. These have accumulated wealth and now face more difficulties to fly out

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[5] *There has been four stages in the concentration of ownership in Russia;*
*- 1st stage: mass privatizations of asset companies in 1992-1994: 50% sold to workers, 9 % to managers, 41% remained in the State hands or were sold to outside shareholders.*
*- 2nd stage: "internal redistribution": managers buy shares cheaply from workers, often with the company's fund.*
*- 3rd stage: "Loans for shares" deal, 1995-1996: the Russian government allowed a small number of financiers – the oligarchs – to buy the state's biggest oil and mining companies at a small price. The aim was to create a business elite to support the re-election of president Yeltsin.*
*- 4th stage: After Russia's default and the devaluation of August 1998, foreign investors and Russians banks sold their share in Russian companies. The oligarch who controlled export of oil and other natural resources had the cash to buy those assets at a very low price.*

their capital. Therefore, they now concentrate on the restructuring of businesses that they control. Not only do they bring in capital but also new management in order to turn around these companies. They can manage both the financial and industrial restructuring of their new acquisition. Furthermore, they have also increased their power to bargain with the government on crucial issues (budget, taxes, import duties, WTO accessions).

This doesn't mean that Russian enterprises will restructure faster, and will be able to fill the technological gap with their western competitors, but these big vertically integrated groups will be one of the important features of the economic development in Russia. As a consequence, as some government experts suggest [Mau, 2002], the government should develop macroeconomic and institutional policies to support and encourage investment by financial-industrial groups. At the same time they will have to curb their monopolistic power and favor the development of capitalism "from below" by favoring the emergence of a new class of private entrepreneurs and the development of SMEs, which today is certainly the weak point of the industrial restructuring in this country.

**Foreign carmakers in transition economies: why entry mode matters?**

Big carmakers from the Triad have followed different path of investment in CEEEs economies, Russia and China [Richet and Bourassa, 2000, Richet, Wang and Wang, 2001]. In CEEEs, carmakers, either to serve local markets or to integrate local plants into their regional or world strategy, have followed acquisition strategies by taking over existing companies or/and building greenfields.

In China, most carmakers have been obliged to set up joint-ventures, with minority capital or just 50-50. Their operations concentrate on some limited segments of production with limited spin offs in the local environment; the remaining part of the partner's assets being managed by local shareholders.

Russia falls slightly under the two cases. On the one hand, foreign companies will set up greenfields; on the other, they will create joint-ventures to cooperate on some segments of production: jointly assembling cars, produce parts. In a way, Russia's case is closer to that of China, as there is no possibility for carmakers to take the majority control of a Chinese company [Richet, Wang and Wang, 2001].

## Acquisition and integrating strategies in CEEEs: the integration model

With the opening up of former socialist economies, the landscape in the car industry in the region (Central and Eastern Europe) has deeply changed. In almost all countries of the region, existing manufacturers have been taken over by big European carmakers (or by US based companies in Europe, such as GM). Western car makers have entered those markets through *greenfield* investment strategies, building new plants from scratch (Poland, Hungary) and acquisitions, turning around existing companies (brownfield investments) such as Skoda, Dacia, FSO. In both cases, this strategy meant the integration into the network of theses companies, which develop regional/continental strategies for designing, producing, outsourcing or marketing. This is particularly the case of first movers such as Volkswagen, GM/Opel, Renault in Europe. (table 1).

***Table 1:*** *Passengers Car Production by Leader Manufacturers, in CEEEs and Russia (‘000)*

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|
| **Volkswagen/ Audi/ Skoda** | 569 | 482 | 584 | 650 | 694 | 736 | 750 | 750 |
| **AvtoVAZ** | 595 | 630 | 660 | 660 | 670 | 670 | 670 | 670 |
| **Fiat** | 334 | 350 | 360 | 360 | 360 | 360 | 360 | 360 |
| **Daewoo** | 198 | 215 | 245 | 250 | 260 | 260 | 330 | 350 |
| **GM/Opel** | 35 | 70 | 100 | 140 | 160 | 170 | 180 | 190 |
| **Renault** | 128 | 115 | 120 | 120 | 125 | 130 | 135 | 140 |
| **Dacia (Renault)** | 88 | 90 | 100 | 100 | 105 | 120 | 125 | 130 |
| **Total** | 1947 | 1952 | 2169 | 2280 | 2374 | 2446 | 2550 | 2590 |

*Source: The Economist Intelligence Unit, 2000*

The acquisition of Skoda by VW has allowed the German car maker not only to get a monopoly position on the Czech market, to control the network of a well known brand in the former socialist countries (Russia, Ukraine), but also to allow its further regional penetration of these new markets. It has also allowed VW to make both economies of scale (volumes) and scope (models) by integrating the Czech plant in its regional strategy. Skoda produces parts for other VW divisions while the Czech plant can rely on parts and components produced elsewhere by other partners of the group. The integration in these networks had another effect on suppliers’ networks and on outsourcing as well. In order to supply the new plants directly, many subsidiaries have accompanied the move of VW in the Czech Republic or in Hungary. Sometimes this involved merging with local suppliers, who didn’t have the technology or

couldn't reach by themselves the minimal efficiency size. Renault in investing in Slovenia or in Romania is following a similar strategy. It chose to be present in the continent either to take advantage of low costs of factors or launch new products for new markets and new consumers.
This is slightly different for second comers. These (Ford, PSA) are looking more for some cooperation with local manufacturers to produce volumes and to tape on local resources than to take advantage of local resources by integrating them in their regional networks. They also try to buy market shares (marketing, after sales services) in order to build a strong hold in these countries.

Another factor that has to be taken into consideration is the level of country-risk for foreign investors. This is particularly true for the car industry. The industry relies on a high level of externalization that is a big part of the production has to be undertaken outside the assembly plant.

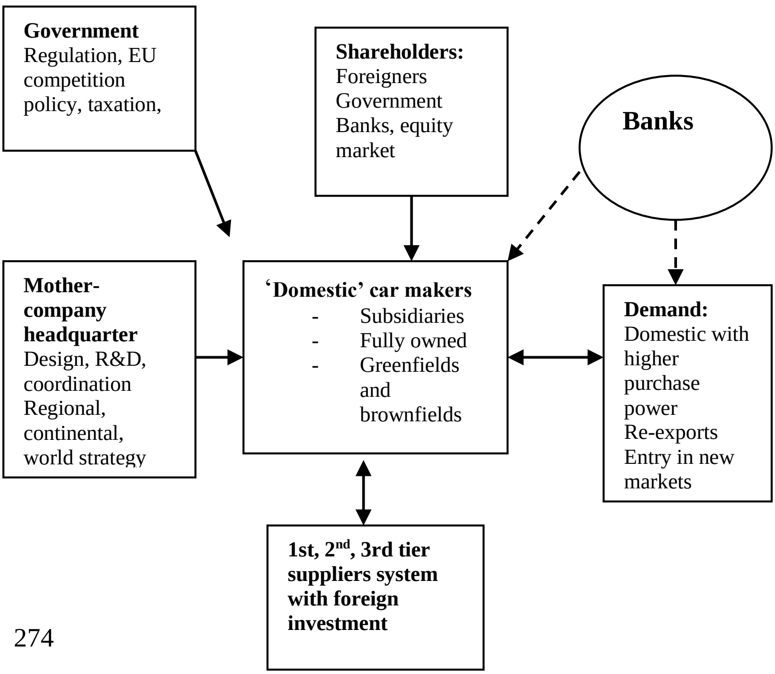
This leads foreign investors to arbitrate between two entry mode in these countries (Figure 1), all of them choosing some kind of industrial cooperation which is more or less difficult to settle and is time consuming but allows the reduction of transaction costs and information asymmetry, to better assess the real commitments of partners in the deal. As far as transaction costs are high, property right unclear, friendly local environment missing, foreign investors will favor direct export of cars or stay at a low level of industrial cooperation (representative office, agreement on the transfer of very limited technology), "a wait and see" strategy. Long delays to reduce transaction costs have pushed several carmakers to limit their entry, to postpone investments and to favor direct exports with limited added-value in the host country (see, for instance, Renault in the first entry stage in Russia).

On the other hand, countries that have opened their markets to direct investment, reducing barrier to entry and shown a real commitment to develop industrial partnerships (such as Hungary, Czech Republic, Slovakia, Poland, Romania) have witnessed a rapid change of the industrial setting in this field. This meant the development of both brownfield and greenfield investments leading to an integration model (figure 2) into the regional/continental strategy of the Western carmaker [Richet and Bourassa, 2000]. Direct investments in Central Europe now account for 15% of the total output of VW. Although local markets are expanding, exports are crucial, representing 90% for Hungarian and Slovakian output and 80% for Skoda [Financial Times, 2002]. This integration has led to a deep restructuring of existing plants, and an increase of productivity, almost to European levels (with labor costs only 25 % of those in Germany). But it has also forced Western suppliers from first, even from second tiers to invest in theses countries forcing them to merge with local suppliers, and therefore contributing to create a new industrial belt in the region by fuelling the integration process with Western European carmakers.

***Figure 1:*** *Entry Mode, Country-Risk, and Commitment of Foreign Investors*

| Level of country-risk | Entry Mode | Entry coordination |
|---|---|---|
| High | Product exports, Licenses, Technical Assistance | Entry through commercial strategies |
| Medium | Joint-venture often with a minority stake<br>- Legal constraints<br>- wait and see strategy | |
| Weak | Acquisition : external growth of the firm<br>Greenfield : internal growth of the firm | Entry through commitment and vertical integration |

***Figure 2:*** *The Integration Model*



### *Restructuring the Russian car industry: a new playground for foreign Firm?*

The renewal and future development of the Russian car industry is directly linked to several factors on both sides of the market. On the demand side, it relies on the growth of internal demand fuelled by the amelioration of the population's living standards, on the development of a sound credit system and also on the capacity of big Russian car manufacturers to regain and to extend its market shares on their traditional markets (in the former FSU, India, Middle East, Latin America). On the other hand, Russian car makers have to cope with the new competitive environment; the presence of foreign car makers in the country, the lowering of tariffs and, in the near future, the new constraints coming from the WTO regulation - if Russia becomes one of its members and cannot negotiate exemption in order to reduce the level of foreign competition.

In spite of the 1998 crisis, which has strongly affected sales in this sector, the car market in the country should continue to grow (table 2). The economic situation should push car manufacturers to adjust by investing in new facilities, R&D, and production technologies. This should allow Russia to overcome the main obstacles to its rapid modernization.

***Table 2:*** *Vehicle Output Forecast in Russia (in units, 1997-2005)*

| **Year** | **1992** | **1997** | **1998** | **1999 (1)** | **2000** | **2001** |
|---|---|---|---|---|---|---|
| **Cars** | 963.0 | 981.9 | 841.5 | 475.5 | 1100.0 | 1200.0 |
| **Trucks** | 562.2 | 148.6 | 143.0 | 82.1 | 180.0 | 200.0 |
| **Buses** | 48.1 | 43.4 | 42.7 | 26.8 | 50.0 | 55.0 |
| **Total** | 1597.3 | 1173.9 | 1027.2 | 584.4 | 1330.0 | 1455.0 |

| **Year** | **2002** | **2003** | **2004** |
|---|---|---|---|
| **Cars** | 1300.0 | 1400.0 | 1500 |
| **Trucks** | 220.0 | 240.0 | 270.0 |
| **Buses** | 60.0 | 65.0 | 75.0 |
| **Total** | 1580.0 | 1705.0 | 1845.0 |

*Source: Carana Corporation*
*(1): data as of January-June 1999*

The opening up of the Russian economy has favored the import of foreign cars, and eventually used ones. Strong domestic competition is present even at a very low price. This is today a major concern for the main domestic carmakers (AvtoVAZ, GAZ). They are facing strong competition from imported cars on the Russian market and are hit by the change of customer demand towards better and pricier imported or domestically assembled cars by foreign makers.

In consequences, all major companies (table 3) have looked to make deals with foreign investors in order to up-grade their production, have access to new technologies and efficient distribution networks. Most of them paid this greatly, facing dramatic financial situations (accumulation of debt taxes, lack of investments, products with no future).

AvtoGAZ, is one of the largest and most advanced manufacturers, producing more than 2/3 of Russian cars. Hit by imports of foreign cars, their management has been unable to respond to the new challenges, and the company has lost market shares to imports as well as to more market-oriented competitors (GAZ). The company still has a very low productivity level and needs to be reshaped with foreign investment, without the need to alter significantly the dominant ownership. The company has negotiated a project with GM and the EBRD to set up a joint-venture to produce two kinds of cars: a revamped model of off roads *Lada Niva* and *Opel Astra*. On the other hand, shareholders of the company are lobbying the Russian government to prevent the entry of imports of used cars. It is interesting to measure the technology and product quality gap by mentioning that 6 year old Western cars entering Russia are the main competitors of the low range products in which Russian car makers have their dominant market shares (they sell around the same price, between 5000-6000 US $).

***Table 3:*** *Original Plans for Foreign Investment*

| **Brand** | **Local Partner** | **US$m** | **Annual Capacity** |
|---|---|---|---|
| BMW | Avtotor | 26 | 10 |
| Chevrolet | EIAZ | 50 | 50 |
| Fiat | GAZ | 500 | 150 |
| Ford | Bankirski Dom | 150 | 100 |
| Lada/Opel | AvtoVAZ | 2 350 | 310 |
| Opel | AvtoVAZ | 200 | 150 |
| Renault | City of Moscow | 300 | 120 |
| Skoda | Izhmash | 250 | 80 |

*Source: Just-auto.com (2000)*

GAZ, a more diversified producer, has also been faced with difficult financial issues. After the reception of a loan from the government, towards production line modernization, the company started to focus on marketing and set up a dealer network. Two new products, *Gazelle*, a light commercial vehicle and more heavy truck *Sobol* have contributed to boost sales. In the same time, the production of the passenger car *Volga* has been upgraded and has contributed to keep its market share as the car remain at least twice less expensive than imported cars of this range. The company is considered as the best positioned Russian manufacturer today. This regards its restructuring, new investment, and development of new models and commitment of its management. Recently, the big aluminum financial and industrial group, Sibal (Siberian Aluminum) has taken strategic stakes in the company threatening a deal with Fiat. Fiat considered an industrial cooperation with GAZ in order to launch a new generation of low cost platforms producing cars to be sold on emerging markets. Renault intends to develop the same strategy with its Dacia acquisitions in Romania and its further expansion in its Moscow joint-venture, Avtoframos, launched in partnership with the Moscow municipality

The new owner of GAZ, Sibal has undertaken a deep restructuring of the top and medium management of the company. Sibal, as other big financial and industrial groups, is undertaking a strategic move. It takes stakes in downward industries and uses its output only after the company is willing to create more value and has lost the advantage of low prices of electricity charged by the federal monopoly, EUS, running electricity networks. It has also invested in other car companies (UAZ, in bus companies).

GAZ has been relatively successful in restructuring its scope of products and its organization (although productivity fall far behind the levels of Western firms), its cooperation with Western manufacturers focuses on the supply of different kind of components and parts with German, Austrian and US companies (diesel engines, fuel filters, fans, car design). For both Russian and foreign companies working in the country, one of the main difficulties facing the up-grade of production is the low level of quality of products delivered by suppliers.

## Difficult entry for foreign car makers

Foreign companies investing in Russia face high transaction costs, entering in long discussions with their partners (domestic car makers, local and federal government, banks) is necessary in order to set up their cooperation. Being a strategic sector, the government is concerned that such direct deals are not enough to modernize the sector and that some kind of horizontal and sectoral industrial policies should be implemented. That is why the Russian government sets the rules, and to some extent expresses the wishes of the strong lobbies of the industry.

Main Russian carmakers have been discussing with foreign car makers and part suppliers to encourage their investment in new joint-venture in Russia. The negotiations are about jointly producing new models or revamp and sell existing Russian models (Lada Niva). In other cases joint-venturing concerns supply of parts, engines and other components that are introduced in order to upgrade existing models (GAZ Volga for example) (table 3). A few carmakers consider directly building foreign models from *greenfield* investment (generally without the collaboration of local makers), as Ford (Focus) and Renault (R19, Mégane), which have turndown a strategic alliance with AZLK Moskvich (figure 4).

With high transaction costs and high barriers to entry, four entry modes are possible for foreign carmakers. All four are alternative but also sequential:

1. Importing cars to sell on the Russian market (buying market shares): Mercedes, Peugeot, Toyota.
2. Importing cars and/or parts to be assembled in Russia with the prospect to develop further investments to attain 3 and 4: Renault. Foreign carmakers follow two strategies for assembling cars. First, a complete knock down (CKD) and semi knock down (SKD) assembly lines with limited capacity importing almost 100 percent of components (BMW in Kaliningrad, GM in Yelaguba and Renault in Moscow),
3. Negotiating cooperation deals with local makers, on some segments, without going further in the cooperation ( no equities in the main business): GM and AvtoVAZ
4. Creating a joint venture or a greenfield investments (Ford, Renault), using local assembly lines utilizing at least 50% of domestic content (Ford) to produce foreign brands in Russia.

Generally, in all cases, discussions have been long, initial projects revised, discussion with local government bodies time consuming. Renault had to have more than 236 authorizations to start importing and assembling cars in its Moscow site and has supported no less than four official inspections of its facilities. Other investors mention endemic corruption of some administrations, the difficulty to set network of dealers, up-grading quality of parts delivered by Russian suppliers. As a result, there are long delays and an important gap between initial projects and their development.

The launch of a joint-venture between GM and AvtoGAZ in Tolyatti illustrates the difficulty to negotiate and to strike a deal. It is significant in that it shows the means that have to be put together (facilities, equipment and know-how from the Russian side, cash and some equipment from GM side, finding an extra investor, the EBRD), the taxation of imports according to the degree of “russification” of parts, the quality control of parts (which in the case of the new model assembled can reach more than 50% arriving defective) as well as the stages necessary to increase the volume of production on the new line (which will represent 10%) of the total of AvtoVAZ total output.

***Table 4:*** *Investment Plans of Foreign Car Makers in Russia*

| **Foreign Makers** | **Fiat** | **Ford** | **GM** | **Renault** | **Skoda** |
|---|---|---|---|---|---|
| **Name of Venture** | ZAO Nizhzgorod Motors | Ford Vsevolozhsh | Undecided | OA0 Avtoframos | Skoda Auto Udmurtia |
| **Location** | Nizhny Novgorod | Vsevolozhsk (near St Petersburg) | Togliatti 1000 km southeast Moscow | Moscow | Izhevsk 1 350 km east of Moscow |
| **Local Partner** | GAZ | Bankirski Dom | AvtoVAZ | | Izhmash |
| **Ownership** | 40% Fiat, 40% GAZ, 20% EBRD | Undisclosed | 43% AvtoVAZ 43% GM 14% EBRD | 50% Renault, 50% city of Moscow | 75% Skoda 25 % Izhmash |
| **Investment Plan** | Orinaly $850 m, now $300m | $150m | $500-$600 | Initially $420m Currently $300m | $250m |
| **Start of Production** | Originally Mid 2000, now 2002 | Mid-2001 | Q4 2002 | Initially 1999 Postponed | 4 000 in 2000 100 000 in 2005 |
| **Products** | Palio, Palio Weekend, Sienna | Focus | Lada Niva 2113, maybe Opel Astra T3000 (badged Chevrolet, model names may change) | Megane Classic R 19 | Felicia, Fabia in 2002 |
| **Annual Capacity/ Pro-duction target** | Originally 150 000, now 75 000 in 2 shifts | 25 000 in 2002 | 75 000-90 000 units/year in 2 shifts (target 2005) | Initially: 120 000 Currently: 100 000 | Initially: 80 000 Currently: 100 000 |

*Source: Just-auto.com*

For suppliers, entry is easier for there are lower barriers to entry. Very few Russian automobile components are able to compete with western companies due to ineffective management, outdated technologies and equipments, and lack of financing for modernization. Big suppliers are already present on the Russian markets such as Bosch, ZF, VDO/Kienzle, Steyr. Other main players are considering entering the market, among them: Breed, Delphi Automotive, GKN, Johnson Controls, Magneti Marelli, Valeo.

With the growth prospect of vehicle production in Russia – Russia is considered as one of the six most promising emerging world markets for auto vehicles and as one of the greatest growth market for the next 10 to 20 years - pressures to reduce costs and to maximize local content will be higher bringing suppliers to invest more heavily in the country.

One outcome of this cooperation is that the cooperation model (figure 3) departs from the integration model, which has resulted from the strong presence of carmakers in CEEEs. In the cooperation model, car assemblers and suppliers are still strongly connected, and this is reinforced by the vertical integration strategy followed by shareowners. Competition is weaker because of the State has an ambiguous strategy of the Russian State; trying at the same time to promote the entry of foreign investors and to protect domestic makers by rising import taxes.

**Can an industrial policy fill the technological and organizational gap with western carmakers?**

The Russian government has issued, in 2001 a memorandum on "*The main directions of the State Policy for Development of the Automobile Industry in Russia until 2005".* This memorandum assessed the importance of this sector in the economic growth, its impact on the whole industry with upward and downward effects on other industries from raw material to more sophisticated industries such electronics (50% of the cost of a car is spent on materials and components) not to speak of other services directly related (finance, insurance, aftermarket services – dealers, repairing). In the first part of the 90's, most car companies were unable to raise the capital needed in order to modernize their facilities, few companies have been able to overcome the main weaknesses of car industry: heavy fuel consumption, non-conformity to modern ecology and safety standards, high dead weight and lower degree of safety.

According to this report, a positive policy should aim at reaching different objectives:
- to break down and externalize the big car complexes by concentrating on core businesses as in Western companies (engine, body production, electronic devices, assembling) and relying on outsourcing for the supply of other

components which can be produced at lower prices by external and independent business units.

- to facilitate the transfer of technology in order to upgrade existing facilities, create new assembly lines, and produce new vehicles of domestic concept and vehicles under license meeting international standards with the objective to progressively increase the Russian content of parts.

Another dimension of the program points out the necessity for Russian car makers to concentrate on R&D, to produce up to date components in high value-added sectors of the business such as engine, gearboxes, drive axle, components and systems for brake operation, or modern suspensions systems. This would help to integrate production, design and technological improvements by shortening delays, upgrading final products and supplying cars able to support competition from imported makes. This project shows that industrial cooperation with foreign car manufacturers is an important mean through which Russian carmakers will be able to fill the gap and boost the growth of the sector.

Up to now, incentive measures to promote the restructuring of Russian car companies and the development of domestic production have been negotiating on debt arrears with the government, on the one hand, and the adoption of different measures concerning imports of foreign cars and components on the other. The lowering of duties, from 30-33% to 10%, will allow Russian carmakers and foreign makers in the country to feel the competition from abroad.

This may appear quite contradictory with the former policy, which intended to promote the ‘russification’ of the content of parts and component that had to be produced in the country. On the other hand, this measure can be interpreted as a move towards the WTO requirements. This also means that the tycoons at the head of the main companies see their competitive advantage diminished. The range of price on which they could maintain their market share, between 5000 and 7000 US $, is regularly competed by second hand Western cars. The growth of the purchasing power of Russian consumers allows them to reach the upper ladder and move into the next range, where imported cars less than three years and even foreign cars assembled in Russia become more attractive. This explains the long bureaucratic delays in the negotiations with ministries to clear away entry barriers limiting imports of parts and SKD components to be assembled in Russia. This question of tariff duties on imported cars and parts is among the crucial points discussed in the WTO negotiation, especially due to the new competitive environment with a strong increase of domestic demand for second hand cars (an increase of more than 30% in 2002) and periodical closing down of factories (AvtoVAZ, GAZ) for a couple of weeks in order to reduce the piling of unsold cars.

**Conclusion**

The Russian car industry in is the most developed and the most important amongst CEE and CIS economies. Its prospects of growth in the near future are high. But, the industry is slowly recovering, in spite of the continuous decrease of its production levels in the first part of the 90's. Although privatized the 'Russian way', few companies have been able to adjust and to restructure. Most of them continue to manage over-capacities, have high debts and tax arrears. With the exception of GAZ, no one has been able to change their product mix, or develop new models.

Restructuring in this sector means changing the industrial organization by focusing on core businesses in which carmakers have their competitive advantage. It also requires to externalize business organization by building up new networks of suppliers and distributors, as well as upgrading the production, developing new models and integrating new technologies in order to fill the gap with Western makers in terms of quality, standards, efficiency.

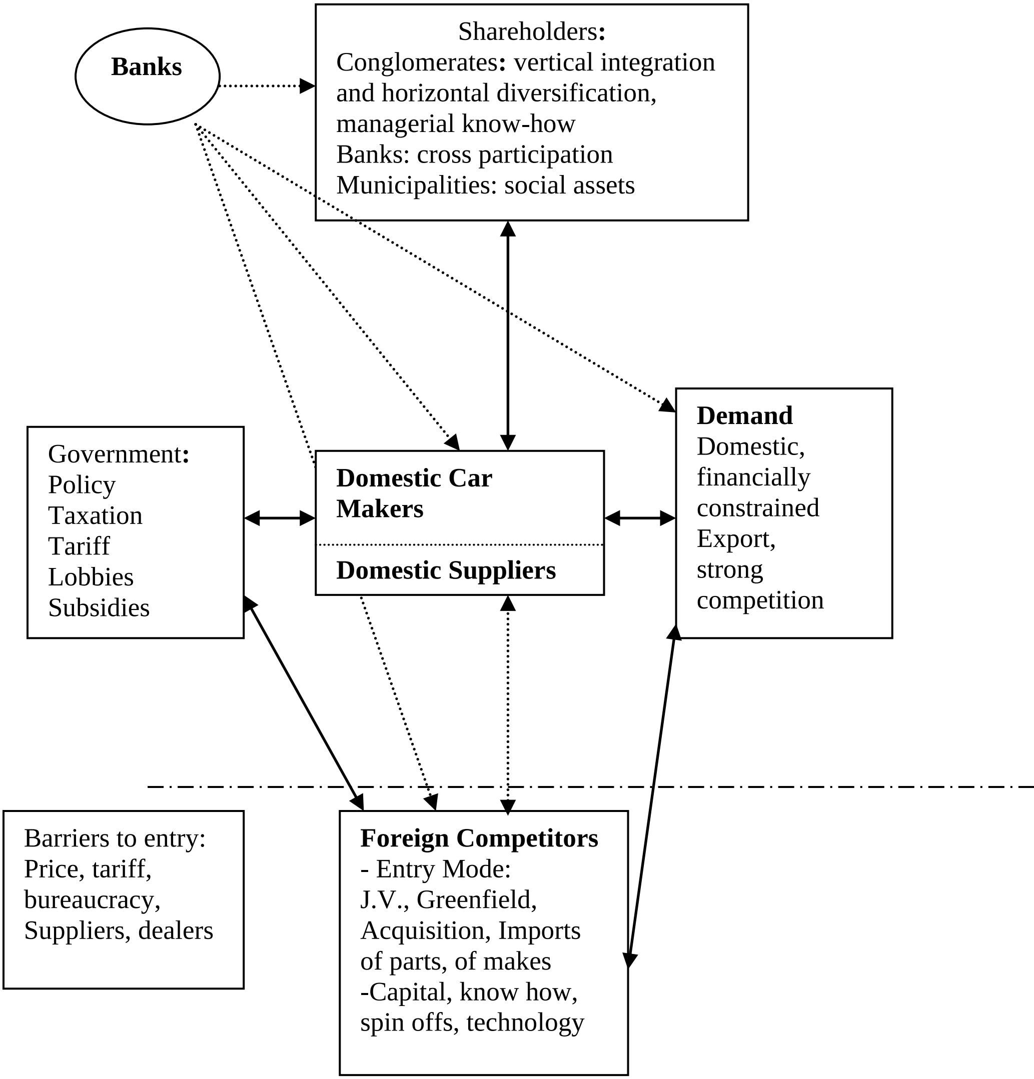
Contrary to what has happened in CEE economies where acquisition and development of new facilities have been the entry mode privileged by Western carmakers, in Russia the entry mode follow another path. Due to country risk, and State regulation, but also to firms' strategy set up by new owners, industrial cooperation through licensing, export of cars and setting up of joint-ventures. Main Russian car makers have developed cooperation on some segments of production by cooperating in the construction of new cars with local maker, by assembling cars or, even, by building up new facilities with the support of local banks or institutions.

In all cases, the setting up of the cooperation has been long due to high transaction costs, to macroeconomic shocks and to other uncertainties generally leading to postpone projects or to reduce the scope of the initially planned project.

Foreign direct investment of Western parts and components makers should increase very stiffly in the near future as modernization of facilities, development of new models (Western, Russian makes) will need to rely on important domestic outsourcing.

Certain factors should have a positive impact on the cooperation with Western companies. Such as changes in the institutional and macroeconomic environment, better growth prospects of the Russian economy, the commitment of the Federal government, regions, municipalities and firms to restructure firms. These should increase the presence of western companies on this market in the future by deepening their relations with their Russian counterparts. But the recovery has a strong price: domestic carmakers will have to cooperate more narrowly with their foreign counter part, open up their capital, come up with the clearing of imperfect privatization by unbundling redundant assets, give away social assets and concentrate on the core business. Nonetheless, it remains to be added that in Russia, as in other emerging market economies (China), the big transnational corporations in this industry will keep the lead and will leave few room for the development of domestic companies which will be facing for long an important technological gap.

**Figure 3 :** The Cooperation Model



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