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Harald Sondhof*

Restructuring Russia's Industry – Taking Stock of the First Five Years of Transition

When the Soviet Union was broken up at the end of 1991, the Russian Federation inherited a large industrial sector which was, however, hardly capable of surviving under market conditions. At about the same time market oriented reforms were begun. What has been accomplished so far? What are the most important tasks that remain to be tackled?

Following President Yeltsin's re-election in July 1996, the prevailing view is that the chances of further progress being made with a market-oriented reform policy in Russia have improved significantly. However, both inside and outside Russia opinions vary greatly as to how much has been achieved by the reforms so far. Undeniably, the economic reforms initiated immediately after the failed coup attempt in August 1991 have still not triggered off an economic recovery even to this day. In fact, Russia's national product as a whole and its industrial production in particular (which still contributed well over 40% of total net output in the early 1990s) have declined on a historically unprecedented scale in the last five years.¹ Just in the period from 1990 to 1994, industrial output fell by more than 50%, while production almost ground to a complete halt in the country's "light industry" (chiefly shoemaking and the garment industry).

It has to be said that expecting market-economic reforms to usher in a swift recovery in Russia's industry was relatively unrealistic right from the start. When the Soviet Union was broken up at the end of 1991, Russia inherited a large industrial sector, but it hardly had the capacity to survive under market conditions. The structural deficiencies in the former Soviet industrial system combined with the collapse of Russian enterprises' old supply and delivery relationships generated problems on a microeconomic level which can only be dealt with in long-drawn-out restructuring processes. To add to these

problems, the market economy reforms were only able to carry a consensus from within society at large for just a short period in the immediate aftermath of the coup attempt. In succeeding periods, the reformers in the Gaidar and Chernomyrdin governments came up against considerable bureaucratic and political resistance.

In that overall environment, the reform steps that have indeed been implemented must certainly be judged positively, as they have laid the foundation for future economic recovery. One particularly successful aspect has been the programme to privatize Russia's industrial enterprises which began in mid-1992 and is still continuing. Privatization is important in that it prepares the institutional ground for the necessary restructuring of Russia's industrial sector. By 1995, the private sector already accounted for 55% of Russia's national product, as against a share of just 4% a decade earlier.² On both macro- and microeconomic levels, the first adjustment responses are now in evidence. Thus a return to the planned economy can now virtually be ruled out.

Difficult Starting Position

Having retained approximately two thirds of the former Soviet industrial potential, the Russian

¹ Cf. Maurice Ernst, Michael Alexeev, Paul Marer: *Transforming the Core. Restructuring Industrial Enterprises in Russia and Central Europe*, Boulder 1996, p. 293.

² Cf. European Bank for Reconstruction and Development: *Transition Report 1995. Investment and Enterprise Development*, London 1995, p. 11.

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Federation is still one of the world's largest industrial nations; approximately 21 million people are employed in 25,000 large and medium-sized industrial plants. However, this legacy goes hand-in-hand with considerable burdens which can only be coped with over a long term. There are a number of reasons why this is so:

□ Management and control over Soviet industrial enterprises used to be exerted by central authorities, leaving little scope for autonomous decisions at the plants themselves. Government ministries appointed all top managers, laid down investment and production plans and organized the distribution of the goods produced. Some of the typical tasks performed by Western-style managements were absent altogether in this system, such as monitoring the marketplace and keeping an eye on the competition, developing new products and drawing up marketing plans. All Soviet directors were responsible for was fulfilling their plan targets, maintaining proper accounts at the enterprise level to establish aggregate production figures, and running day-to-day operations. On the other hand, a relatively important area of activity for Soviet managers relative to their Western counterparts was the administration of their enterprise's social and welfare facilities (e.g. living accommodation, recreation homes, hospitals). The reputation of an enterprise and hence of its management depended to no small degree on the scale and quality of these social and welfare facilities.³

□ Political factors (e.g. military interests) were a greater influential factor in investment decisions in the Soviet economy than were economic facts of life such as scarcity or costs. This gave rise to major distortions in the overall capital stock, the structure of the economy in terms of its different industries, and the size of enterprises. When set against those of Western industrial countries, Russia's industrial sector is disproportionately large: at the close of the 1980s, the sector contributed 24% of the national product in the USA, and approximately 45% in the USSR. Breaking down into industries within the sector, mechanical engineering and metallurgy played a disproportionately large part (see Table 1).

□ Individual production facilities, too, were often remarkably large in size. While about 30% of the

Table 1
A Comparison of the National Product Profiles in the USSR and the USA

Branch of industry	Proportion of National Product (%)	
	USSR (1988)	USA (1986)
Power generation (i.e. electric power)	2.2	3.3
Fuel industry (extracting and processing oil, gas and coal)	5.0	2.3
Iron and steel (extracting and processing iron ore)	3.7	1.1
Chemicals, including petrochemicals	3.1	2.2
Mechanical engineering, metal processing, including armaments industry	15.1	8.7
Timber and paper industries, incl. forestry	2.1	1.7
Construction materials	2.1	0.6
Light industry (producing material and shoes)	6.1	1.0
Food and drink	8.1	2.4
Other industries	1.4	0.3
Total industrial output	48.9	23.5

Source: Lipton and Sachs (1992), quoted in: Maurice Ernst, Michael Alexeev, Paul Marer: *Transforming the Core. Restructuring Industrial Enterprises in Russia and Central Europe*, Boulder 1996, p. 254.

USA's industrial output is produced in plants with more than 1,000 employees, the corresponding proportion in the former Soviet Union was 75%. This discrepancy in the frequency distribution of different plant sizes also grew greater along with the plant sizes themselves; smaller industrial enterprises with less than 1,000 employees – typical of the SMEs or "Mittelstand" found in the market economies, were almost completely absent in Soviet industry.⁴

On the other hand, Western firms which usually operate a number of different production facilities may have more employees in total than comparable enterprises in the former Soviet Union or Russian companies today. In highly developed economies like the USA, approximately 40% of industrial value-added is generated in firms with more than 10,000 employees, and the largest industrial companies have well over 300,000 on their payroll. By way of contrast, only approximately 20% of industrial output in the Soviet Union came from enterprises with more than 10,000 employees. Russia's largest vehicle manufacturers, AvtoVAZ and GAZ, both employ less than 100,000 people (compared with 251,000 at Fiat and 244,000 at Volkswagen).⁵

³ Cf. Simon Clarke: *Formal and Informal Relations in Soviet Industrial Production*, in: Simon Clarke (ed.): *Management and Industry in Russia: Formal and Informal Relations in the Period of Transition*, Cambridge 1995, p. 11.

⁴ Cf. Paul J. Joskow, Richard Schmalensee, Natalia Tsukanova: *Competition Policy in Russia during and after Privatization*, in: *Brookings Papers on Economic Activity: Microeconomics*, 1994, p. 313.

□ Due to the constraints on entrepreneurial activity and the structural distortions arising from centralized planning, the productive capacities of Soviet industry were extraordinarily low. Productivity frequently lagged as much as 50% behind Western standards and quality, too, was substantially lower. For example, the Soviet chemicals industry, employing approximately 2 million people, attained only about one third of the output value of its counterpart in the USA, which employs a similar number; while the American chemicals industry offers sophisticated products, the main emphasis in the Soviet Union was on relatively simple, inorganic products with a low value-added.⁶

The Privatization Process

In September 1990, about one year ahead of the dissolution of the USSR, the first set of proposals for reforming the industrial sector which were not oriented to ideological precepts came under discussion.⁷ However, it was not until after the failed coup attempt in 1991 that a serious reform process actually got moving, when the new government under Yegor Gaidar made implementing a comprehensive programme of privatization its most urgent economic policy goal.⁸ Running parallel to this programme, the government also pushed ahead with a number of other market-oriented reforms.

For Russia's reformers, the transition to a new system primarily entailed pushing the State and the Party back out of the economic sphere. The chief means to that end was the privatization of large industrial enterprises. In making sure that the political *nomenklatura* and the ministries were deprived of their influence, it was accepted that the industrial *nomenklatura* would do well out of the situation, for without its support any reform would have been doomed to failure.⁹ At the time the Soviet Union and

its economic sectoral ministries were broken up in late 1991, the "red directors" had already assumed de facto control of their enterprises.¹⁰ The generous approach taken towards accommodating insider interests – which has largely been regarded as a negative feature of Russian privatization, both inside and outside the country – was not in fact an undesired side-effect, but was seen as a means of implementing the programme in the first place.

Another factor influencing the reforming politicians' cautious attitude towards the industrial *nomenklatura* was that the old directors, having secured de facto control of their plants, would at all events go on to secure rights of ownership. The wave of "spontaneous privatization" in which the rights to parts of enterprises were assigned to private individuals – which amounted to stealing government property – had already gathered pace at the time Gorbachev's Law on Cooperatives was passed in 1989, if not before that. So the situation cried out for the swift implementation of an official privatization programme, because undue delay would have meant that there were no longer enough genuinely valuable assets left for any properly ordered procedure.¹¹

The privatization of large and medium-sized industrial enterprises got under way in December 1992, initially with the help of voucher auctions, and was completed in June 1994. During that period, a total of 16,000 businesses with 17.7 million employees were privatized. The Russian general public swapped approximately 114 million of the 144 million vouchers distributed to them for participating rights in industrial enterprises. Regional coverage was also virtually complete, with 86 of Russia's 89 regions carrying out privatization programmes.¹² After this gargantuan effort – the largest privatization programme in history – Russia now again has a private-enterprise industrial sector for the first time in seventy years, in which management decisions can be taken within individual firms instead of by anonymous government authorities. In mid-1994, a start was made on the second phase of the privatization programme, in which remaining government shareholdings are being sold off to investors via cash auctions. The pace of

⁵ Cf. Top 100 Russian Companies, compiled by Dun & Bradstreet, Financial Times 500, reprinted in *Finansoviye Izvestiya*, 14th March 1996.

⁶ Cf. Jay Mitchell: Chemical Industry of the Former USSR, in: *Chemistry & Energy*, 13th April 1992, p. 48.

⁷ Cf. Alexander Radygin: *Privatisation in Russia: Hard Choice, First Results, New Targets*, London 1995, p.16. Radygin is a member of former premier Yegor Gaidar's staff.

⁸ Cf. Roman Frydman, Andrzej Rapaczinski, John Earle et al.: *The Privatization Process in Russia, Ukraine and the Baltic States*, Budapest 1993, pp. 38-39.

⁹ Cf. Alexander Radygin, op. cit., pp. 27 f.

¹⁰ Cf. Maxim Boycko, Andrej Shleifer, Robert Vishny: *Privatizing Russia*, Cambridge 1995, p. 13. The authors were all directly involved in the privatization process; apart from Radygin's monograph, their book provides the first comprehensive account of the Russian privatization programme.

¹¹ Cf. Alexander Radygin, op. cit., pp. 28 f.; see also Simon Clarke, Veronika Kabalina: *Privatization and the Struggle for Control of the Enterprise*, in: David Lane (ed.): *Russia in Transition*, London 1995, p. 144.

¹² A table showing numbers of enterprises privatized, their number of employees and how many vouchers were cashed in is reproduced in Maxim Boycko, Andrej Shleifer, Robert Vishny, op. cit., pp. 106-107.

cash privatization slowed in the run-up to the 1996 presidential election, but following President Yeltsin's re-election and the re-emergence on the scene of the reformer Anatoly Chubajs, the process is expected to continue with renewed momentum.

More than half of Russia's national product is already now earned by the private sector. Despite its late start, that places Russia in the centre of the field among the transition countries, behind the Czech Republic (70%), Poland (60%) and Hungary (60%), which in some respects already had an appreciable private sector even in planned-economy days, and ahead of Bulgaria (45%), the Ukraine (35%) and Belarus (15%).

Privatization has also provided the basis for a stock market, allowing a crude market valuation of the former Soviet enterprises to be made for the first time. If the maximum voucher trading prices are used as a guide, the total capitalized value of Russian industry when voucher privatization came to a close at the end of 1994 was approximately US\$ 12 billion, or in other words slightly less than the market capitalization of Germany's Hoechst AG (approx. \$ 13 billion). In the past two years, the quoted prices of most Russian industrial businesses have risen, but they are still barely a fraction of the valuation placed on comparable Western firms (see Table 2). Undoubtedly, the low stock market valuations are partly attributable to the substantial political risk and limited market liquidity. However, the old age and poor quality of the capital stock and the poor qualifications of the managements that have largely retained their influence after privatization are further factors in this low capitalization.

Market-Economy Reforms

Privatization has been accompanied by other economic reforms which have considerably intensified the pressure on Russian enterprises to restructure their operations. It is probably fair to say that the pressure exerted on the Russian government by international lenders was an important motive behind the measures: Western lenders attached conditions to their support. The most substantial of the market-oriented reforms include cuts in government

subsidies to industry, a relatively liberal trade policy, and the establishment of bankruptcy law.

□ Payments to industrial enterprises by the Russian government were reduced from almost 32% to just 5% of the total central budget between 1992 and 1994.¹³ This fall in payments, which of itself represents quite a major reforming success, has been partly counteracted by rising subsidies paid out by local and regional authorities, by tax concessions and by increased short-term lending. However, the only industries whose budget constraints are really "soft" at present are coalmining, some parts of heavy industry, and large plants in the armaments industry, all of which received financial support on a substantial scale in the election year of 1996. At the end of 1995, only just under 10% of firms overall were in receipt of state financial support.¹⁴ The fall in monthly inflation rates since early 1995 to reach just 1-2% in May 1996 is proof enough of the Russian government's increased budgetary discipline.

□ Import controls and trade subsidies were virtually abolished in 1992 and 1993. At approximately 13%, the average tariff on imports was comparatively low in 1995; only some specific types of goods such as motor vehicles carried considerably higher rates of import duty.¹⁵ Under pressure from big international lenders, Russia has pledged that it will keep its markets open to foreign competition. Non-tariff barriers to trade (safety standards, licensing requirements, etc.) are also to be further reduced. In some parts of the consumer goods sector, foreign suppliers have already attained a market penetration of over 80%, putting Russian manufacturers under tremendous pressure to restructure.¹⁶

□ The Russian Federation has had a bankruptcy law in place since March 1993, and the law has indeed been applied from the end of 1994 onwards. So far, the newly created bankruptcy authority has declared approx. 5,000 enterprises insolvent. About 400 mainly

Table 2
Market Capitalization of Russian and Western Industrial Enterprises

Industry	Russian Enterprises			Western Enterprises		
	Name	No. of employees	Market value (\$m)	Name	No. of employees	Market value (\$m)
Steel	Severstal	49,400	88	Thyssen	131,000	5,928
Auto	GAZ	96,000	80	Renault	138,300	6,887
Oil	Lukoil	60,000	2,833	Exxon	86,000	94,839

Sources: Finansovye Izvestiya, Financial Times 500, various editions. Based on stock market prices at the start of 1996.

¹³ Cf. EBRD: Transition Report 1995, op. cit., p. 55.

¹⁴ Cf. Tomoko Hanada: Manufacturing in Russia: Three Years into Reform, in: NRI Quarterly, Spring 1996, p. 68.

¹⁵ Cf. EBRD, op. cit., pp. 55 et seq.

¹⁶ Cf. The Economist, 13th April 1996, p. 67.

smaller enterprises have been liquidated, and another 500 are currently undergoing reorganization.¹⁷ Bankruptcy proceedings may be initiated either by an enterprise itself, by its creditors or by a public prosecutor. A specialized bankruptcy court then decides whether the enterprise should be liquidated or restructured. In the latter case, there are again two options, namely restructuring by the old management (*sanatsiya*), or calling in a receiver/trustee. Even though the number of proceedings initiated is still relatively small, observers of the economy believe that the threat of liquidation has now begun to influence companies' behaviour. In some cases, for example, the initiation of proceedings did spur enterprises to pay off their debts.¹⁸

Restructuring Problems in Industry

The problems faced by most of the former state-owned enterprises in their new market environment can only be resolved in the long haul. Even under favourable circumstances, re-engineering an industrial company is a process taking several years, even assuming sufficient expertise is on hand and the management is willing to adapt. Yet the majority of Russian enterprises are headed by directors who tend to have only a limited understanding of the market economy, and who are not themselves subject to efficient surveillance.

For most Russian industrial enterprises, the most urgent restructuring problem is one of developing and subsequently making products which will provide sufficient value for money to be competitive, against both rival domestic products and imports. Since many Russian industrial products are of a very low quality, there is strong pressure to cut costs. Low wages are likely to provide an important factor-cost advantage for some time to come, and another aspect is that Russian industrial workers are often surprisingly well-trained and, as individuals, highly motivated.¹⁹ Nevertheless, these advantages are counteracted by very low overall labour productivity, mainly due to poor organization of work processes and plant and equipment which in some cases are totally obsolete. Moreover, the prices of other production factors and

inputs such as energy and steel are continually increasing: because oil, iron ore and other raw materials are exported on a large scale, domestic customers are now increasingly compelled to pay world market prices for their inputs.²⁰

The new products and new plant the companies need often cannot be financed, as such investment projects usually have to be funded out of their own scarce capital resources. So far, banks have been relatively unwilling to lend to industrial enterprises because of the poor protection afforded to creditors, and they have shown a preference for other types of business such as foreign exchange and securities trading. Similarly, because a voucher system was used, the privatization process itself has not made much of a contribution in terms of real capital formation; the cash auctions are still on just a small scale.²¹ Consequently, the volume of capital investment was still falling in 1995, even after the declines of 15% in 1993 and 28% in 1994.²² Only four out of ten industrial enterprises invested anything at all during 1994; the enterprises' capital stock is being eaten away bit by bit.²³

Unless there is a greater inflow of new funds from investors and banks, this investment crisis is likely to become still more serious, as industrial enterprises are typically generating increasing losses.²⁴ These problems are added to by acute liquidity bottlenecks: because firms have to provide credit to their customers on a large scale to be able to sell anything at all, many of them are operating on the very verge of insolvency. Payment arrears within the Russian economy currently add up to 3-4% of the national product. Government bodies have themselves contributed substantially to the payments crisis by failing to settle bills on time, if at all.²⁵

Inefficient Corporate Governance

The privatization programme has normally strengthened the positions of the old managements who are often unwilling to make deep-seated changes to their companies' operations. In mid-1996, directors

¹⁷ Cf. *The Economist*, 18th February 1995, p. 66.

¹⁸ Cf. Maurice Ernst, Michael Alexeev, Paul Marer, *op. cit.*, p. 267.

¹⁹ Cf. Simon Clarke, *op. cit.*, p. 10.

²⁰ Cf. Konrad Baskaev: *Tarify na elektrichestvo prodalzhayut rasti*, in: *Finansovye Izvestiya*, 30th January 1996, p. 2.

²¹ Cf. Alexander Radygin, *op. cit.*, p. 72.

²² Cf. Bundesstelle für Außenhandelsinformation (BfAI): *Länderreport GUS. Wirtschaftstrends 1995*, p. 49.

²³ Cf. Tomoko Hanada, *op. cit.*, p. 76.

²⁴ Cf. Aleksandra Batyaeva: *Finansovoe polozhenie rossiyskikh predpriyatiy ukhudshilos'*, in: *Finansovye Izvestiya*, 14th May 1996, p. 2.

²⁵ Cf. Evgenia Pismennaya: *Neplatezhi stali dopolnitel'nym istochnikom bazovykh otrasley*, in: *Finansovye Izvestiya*, 9th February 1996.

and their workforces held approximately 65% of companies' equity between them; just under 10% of all the shares issued are in management's immediate possession. Of the remaining equity, 21% is held by outside interests and 14% by government bodies.²⁶

Even though the privatization procedure already favoured managements and their workers, in many cases additional measures were also taken to ward off external investors. For example, voucher auctions might be carried out before the publicly announced date, meaning that only the employees present were able to put in bids. There were also examples of auctions held on company premises with no public access, leaving potential bidders from elsewhere stranded outside the gates. In other cases, vouchers were bought up using an enterprise's internal funds and exchanged for shares; thus the enterprises purchased their own equity in a process which, though illegal, is very difficult to prove.²⁷

Since the boards of the new-born public companies are normally made up of people who enjoy the management's confidence, all major decisions are taken without any effective outside controls. The shareholders' meetings which have to be called once a year have as yet rarely provided any opposing group of shareholders with an opportunity to exert serious pressure on a management or to force its members to resign.²⁸ However, despite their commanding position the "red directors" still need to rely on at least tacit support from their workforces, as they do not have all ownership rights in their hands. In cases of conflict, shareholders' meetings do at least provide the institutional framework for a possible change of power. As a result, managements are very reticent when it comes to restructuring and cutting jobs. Nor are companies likely to sever their links with costly social and welfare facilities against the will of their employees; thus it comes as no surprise that, among the various objectives they have to choose between, many Russian managers place "safeguarding the

working collective" well ahead of any other, followed some way behind by "stabilizing the financial situation".²⁹ This attitude is often all the more prevalent the more difficult a situation the company is in, and the lower the level of capacity utilization. Only a relatively small proportion of the new company directors regard increasing market share or profit maximization as the most urgent objectives.³⁰

Russia's reformers expect the problem of efficient corporate governance to solve itself in the course of time. Certainly, one or two positive trends are now in evidence. Voucher privatization is estimated to have been accompanied by a change of management in about one in ten cases. During the present process of cash privatization, a growing number of companies are now coming under the control of outside investors. They frequently have a much stronger interest in actively restructuring a company than the old management would have had.³¹

First Effects of Restructuring

On a macroeconomic level, the restructuring of Russian industry has already begun. However, active restructuring at the individual company level is still relatively rare because efficient corporate governance has not yet been institutionally guaranteed. The current phenomenon of financial/industrial groups (finansovo-promyshlennye gruppy) being formed could mean that Russia is following the Continental European or Japanese model of corporate govern-

Table 3
Russia's Changing Output Profile, 1991-1994
(at current prices for each year)

Branch of industry	1991	1992	1993	1994 ^a	1991 ^b
Power generation	4.0	6.4	9.2	13.1	12.4
Fuel industry	7.3	18.5	17.2	17.3	25.7
Metallurgy	11.2	16.7	17.1	16.2	7.9
Chemicals	6.5	8.0	7.2	7.3	2.2
Mechanical engineering	24.9	20.1	20.0	18.5	19.0
Timber and paper	5.8	4.8	3.9	4.0	13.5
Construction materials	3.7	3.3	3.3	3.9	5.4
Light industry	16.2	7.1	5.2	3.0	2.9
Food and drink	14.4	10.3	12.4	12.2	8.2
Other industries	5.9	4.9	4.6	4.4	2.8
Total	100	100	100	100	100

^a January-September only. ^b Output in 1991 valued at 1991 world market prices.

Source: OECD: Investment Guide for the Russian Federation, Paris 1996.

²⁶ Survey conducted by Josef Blasi and Katarina Pistor, quoted in Maxim Boycko, Andrej Shleifer, Robert Vishny, op. cit., p. 111. Similar conclusions have been drawn by the Nomura Research Institute: cf. Tomoko Hanada, op. cit., p. 77.

²⁷ Cf. Alexander Radygin, op. cit., p. 66.

²⁸ Cf. Simon Clarke, Veronika Kabalina, op. cit., p. 149.

²⁹ Cf. Maurice Ernst, Michael Alexeev, Paul Marer, op. cit., p. 254.

³⁰ Cf. Kapeliushnikov and Aukutionek (1994), quoted in Maurice Ernst, Michael Alexeev, Paul Marer, op. cit., p. 255.

³¹ Cf. Maxim Boycko, Andrej Shleifer, Robert Vishny, op. cit., p. 113.

ance, with large banks exerting a dominant influence on industrial corporations.

□ The share contributed by the industrial sector to Russia's national product fell from 42.9% in 1991 to 36.7% in 1994. The largest falls in output during that time occurred in mechanical engineering, and in downstream light industries (see Table 3). Mechanical engineering, which also includes armaments manufacturers, was most severely hit by cuts in subsidies; the inevitable down-sizing of the industry is now obviously gathering pace. In the case of light industry, on the other hand, the main problem has been the loss of market share in competition with imported goods, which has meant substantial cut-backs in output. Foreign products are vastly superior to Russian ones in terms of quality, and sometimes also in terms of price.

The main beneficiaries of structural shifts to date have been industries at the raw materials end of the production chain, i.e. electricity generating and fuel extraction. The indirect subsidies provided to inefficient industries in the form of cheap raw material inputs have now been eliminated as prices and trade have increasingly been liberalized. Increased sales of Russian raw materials on the world market have made a substantial contribution to the country's trade surplus in the last few years.

□ Active corporate re-engineering has so far been confined to just a few cases. To cite a more typical example: AftoVAZ, maker of Lada automobiles and Russia's largest supplier in the market, had to resort to short-term borrowing of approximately \$ 500 million in 1994 compared with a turnover of approximately \$ 2.5 billion. The firm has not brought out many new models in the last twenty years. Even though output increased slightly in 1995 to reach approx. 600,000 units, thanks to the protection afforded to Russian-built cars by high import tariffs on foreign vehicles, it is as yet impossible to see how the company might become competitive in the long term.³²

On the other hand, a rare example of active management policies to cope with the restructuring tasks at hand is provided by the GAZ commercial vehicle producer in Nizhny Novgorod. Three years

ago, the company put a new light truck (the "Gazelle") on to the market, and it attained sales of almost 60,000 units of these in 1995. The Regional Governor in Nizhny Novgorod, Boris Nemzov, has considerable influence over the company, and is generally regarded as an enlightened reformer.³³ Overall control of GAZ is held by a financial-industrial consortium with a banking group at its core.

□ The formation of these "financial-industrial groups" (FIGs), drawing together industrial enterprises and banks, is a phenomenon peculiar to the transition in Russia. The predecessors of the FIGs were industrial federations founded jointly by ministerial bureaucracies and parts of the industrial *nomenklatura* shortly before the official privatization programme got under way in mid-1992. The privatization authority did not permit such groupings within the privatization process, as it feared that unfettered horizontal mergers would give rise to uncontrollable monopolies which would be dominated by the old political *nomenklatura*.³⁴

Nevertheless, a new class of Russian entrepreneurs are pushing ahead vigorously with the formation of FIGs, with the aim of accumulating capital and restructuring industry; they have some degree of support from the Russian government, which believes the development of conglomerates with financial muscle will lend support to the restructuring process.³⁵ In addition, because there is no really liquid capital market available, they have a further important role to play in injecting funding into industry.³⁶ On the other side of the coin from these potential advantages, there is the danger that the new conglomerates could prove "too large to fail", creating substantial political pressure for government subsidies. Moreover, FIGs which dominate whole industries have to be viewed critically from the point of view of upholding competition.

It is too early yet to say in what direction the FIGs will develop; however, there can be no mistaking their growing economic significance. At the start of 1996, the number of financial-industrial groups was estimated to be about 50. There are already about three million people working in industrial plants under the control of FIGs. Six relatively large groups have emerged, all with their main emphasis in different

³² Cf. AftoVAZ podpiset kontrakt, in: *Finansovye Izvestiya*, 18th June 1996, p. 3.

³³ Cf. Stepan Pavlov: GAZ rashyryaet sferu deyatel'nosti, nesmotrya na dolgi pered byudzhnetom, in: *Finansovye Izvestiya*, 15th March 1996, p. 2; R. Arifdyanov, S. Mostovshchikov: Nizhniy - Zametki o stroitel'stve kapitalizma, in: *Izvestiya*, 6th March 1996, p. 5.

³⁴ Cf. Paul J. Joskow, Richard Schmalensee, Natalia Tsukanova, *op. cit.*, p. 346.

³⁵ Cf. *Wall Street Journal*, 7th February 1996, p. 5.

³⁶ Cf. Masahiko Aoki, Jyung-Kim: Corporate Governance in Transition Economies, in: *Finance & Development*, September 1995, pp. 20-22.

industrial fields, and with their own connections to the holders of political power (see Table 4).³⁷ Oneximbank has grown out of the former foreign trade bank of the USSR. The Menatep Bank has its roots in the former communist youth organization, Komsomol.³⁸ Prime Minister Viktor Chernomyrdin is himself said to hold a large stake in Gazprom, the highly profitable monopoly in Russia's natural gas industry.³⁹ All groups make use of their political contacts to take control of the most valuable capital assets in Russia's industrial sector.

Because it so obvious that they have had favoured treatment, the FIGs have come under immense political pressure in the recent past. The 1995 loans-for-shares programme proved especially controversial. In this arrangement, major banks, usually represented via an FIG, were able to obtain large shareholdings in lucrative oil, transport and precious metals companies in return for agreeing to provide loans to the Russian government.⁴⁰ Most of these auctions were organized in such a way that foreign bidders would be excluded, and in some cases bids made by Russian participants also failed to be taken into consideration. It is unclear at present whether and to what extent a review of the

privatization procedure now being conducted by the Russian parliament might lead to the renationalization of some enterprises.⁴¹

Outlook

The most important outcome of the Russian transition process is that a return to a planned economy can be practically ruled out today. As a result of privatization, the central planning bodies have given way to numerous powerful economic "stakeholders" who now have too much to lose, and would hardly look on passively if renewed large-scale nationalization were to occur. However, it will not be possible in the short term to resolve the crisis in the industrial sector. The structural deficiencies in the former Soviet economy can only be overcome by a thoroughgoing, long-haul restructuring process which will often call for drastic measures to be taken on a microeconomic level. At the same time, many Russian industrial enterprises need to develop new markets, to cut production costs and to establish new organizational structures – and the people who have to do this will frequently be managers whose own behaviour and interests are still shaped by the old system.

In addition to further macroeconomic stabilization measures and improvements in the economic policy-making environment (especially on the tax legislation front), another essential prerequisite for successful restructuring is that efficient forms of corporate governance should be developed. The financial-industrial groups currently developing may be able to play an important part in this and to act as a driving force in the renewal of Russia's industry. All in all, the chances today are better than they have yet been that Russia will now enter a phase of real economic recovery after its years of declining industrial output. For that reason, Russia is also likely to grow more attractive to the foreign investors who have so far avoided any large-scale involvement.⁴²

Table 4
The Largest Financial-Industrial Groups
in Russia, 1996

Name	Industrial Holdings	Political Connections
Onexim	38% of Norilsk Nickel, 26% of Perm Motors, 26% of ZIL (trucks), plus other holdings in oil, metal industries and real estate	Direct links to the Kremlin
Menatep	Highly diversified, 78% of the Yukos oil company, majority stakes in plastic, metal, textile, chemicals and foodstuff producers	Former party members (Komsomol)
Alfa	Concentrated in the Moscow region, with interests in real estate, financial services, cement, confectionery and chemicals industries	Not known
Rossiskaya Metallurgiya	A conglomerate of fourteen iron and steel enterprises with financial problems formed by presidential decree	Former deputy prime minister Oleg Soskovetz
Most Group	Concentrated in the Moscow region, with diversified holdings including banking, real estate, construction, and stakes in the NTV television company and newspapers	The mayor of Moscow, Yuri Lushkov
Gazprom, Lukoil, Imperial Bank	Loose, politically influential conglomerate with a dominant influence on the oil and gas industry, and substantial foreign exchange earnings from Europe and the Middle East	Prime minister, Viktor Chernomyrdin

Source: Business Week, 1st April 1996, p. 24.

³⁷ Cf. P. Galuska: The Battle for Russia's Wealth, in: Business Week, 1st April 1996, p. 24.

³⁸ Cf. Jörg Eigendorf, Katrin Schut: Die Macher von Moskau, Düsseldorf 1994, p. 52.

³⁹ Cf. Forbes, 11th September 1995.

⁴⁰ Cf. Wall Street Journal, 3rd/4th November 1995, p.3.

⁴¹ Cf. Elena Krivyakina: Gosduma gotovit novuyu pravovuyu bazu privatizatsii, in: Finansovye Izvestiya, 23rd May 1996, p.4.

⁴² Cf. Michael Obermayer, Harald Sondhof, Thomas Veraszto: Der Blick auf die politischen Risiken lähmt die Investoren. Markteintrittsstrategien für die Russische Föderation, in: Blick durch die Wirtschaft, 29th April 1996, p. 11.