

NEWSLETTER

INTERNATIONAL

 ENGLISH VERSION

RUSSIA



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## “WE HAVE TO GET USED TO NEW NORMAL”

**The Russian government has been pursuing a determined import substitution policy since 2014. How did this impact the Russian business of Finnish companies?**

The Finnish-Russian Chamber of Commerce conducted a survey at the end of last year, which was dedicated to gather data on the effects of the import substitution policy for Finnish companies.

The survey showed that western technologies are required for the modernization of the Russian industry and the localization of production.

Accordingly, the import substitution program and the current localization processes have created opportunities for Finnish suppliers of equipment and machinery. About 35% of the Finnish exports to Russia are investment goods.

However, the Finnish companies that were interviewed for the survey found challenges as well as opportunities in the current environment. The major challenges are the absence of financing in Russia, the low investment activity and, of course, the weak economic outlook.

For those Finnish companies that are basically prepared to localize, the lack of local supply chains and the weak industrial infrastructure make the establishment of production facilities difficult.

**How have the Finnish companies reacted to the new market environment which has emerged over the last two years? Can you name any major localization projects of Finnish companies?**

According to the “Barometer of Russian Business” that we carried out last autumn among our member companies, about 20% of Finnish companies had taken import substitution policy into account in their business.

Because of the unstable economic situation on the Russian market, most of the companies have reacted by adjusting their activities to the new situation. That means reducing expenses, or in some cases intensifying marketing efforts. Only very few companies have decided to exit the market.

There are examples of localization projects of Finnish companies, with most of them being in the field of construction materials:

**Skaala Oy** - new factory for window production in St. Petersburg;

**Nor-Maali Oy** - green field project for production of industrial paints in Moglino (Pskov region);

**Rudus Oy** - production line in Vyborg;

**Uponor** - production of pipelines in the Leningrad region;

**Myllyn Paras** - factory for cereals production in Domodedovo (Moscow region).

**Do you expect the import substitution policy to be limited in time? How likely is it for European companies to be able to return to export-driven business models in Russia?**

The import substitution policy has been one of the topics of discussion in Russia for a longer time, but it is obvious that sanctions and counter-sanctions accelerated the process. I assume that we have to get used to the “new normal”.



**Jaana Rekolainen**

is CEO of the Finnish-Russian Chamber of Commerce (FRCC). The FRCC is a non-profit organization, whose mission is to promote companies' business and competitiveness as well as economic relations in Russia and Finland.

As result of sanction policies and import substitution the rules of the game have been changed, but it is obvious that there will still be huge opportunities for export. We have to also keep in mind that the goal of the import substitution policy is not a total replacement of import by local production, but to restrict the dependence on import.

### **How will the Russian economy and the Russian-European economic relations develop in the next three years?**

The impact of the oil price is very important for the Russian economy. Given that the oil price will remain at the current level, the Russian economy will recover, but very slowly. Russia needs major structural reforms in order to enable better growth. Accordingly, we cannot expect a rapid increase of exports from Europe to Russia. I do not like to talk politics, but we must admit that today the role of the development of the political and geopolitical situation is essential also for the economic relations. Anyway, I see more reasons for optimism now than, for example, a year ago.

INTERVIEW

## “IMPORT SUBSTITUTION IS A POSITIVE TREND FOR RUSSIA”

### **Over the last two years, the ruble has devaluated by almost half against the euro and the Russian government has been pursuing a determined import substitution policy. How did these factors impact HARTING’s Russian business?**

These two factors impacted HARTING’s Russian business strongly. We needed to reconsider our strategy and business focuses.

The first factor, namely the volatility of the ruble, is mainly due to volatility of the oil prices and the sanctions, and here we can do nothing.

We consider the second factor, a determined import substitution policy, as a very positive trend for Russia. If it is implemented in the right way, it will enhance the competitiveness of Russian products on the international markets.

Our components are widely used in local products of high quality, where safety and reliability at reasonable prices are key factors. As a result, our business in Russia grew noticeably during the last two years.

### **How did HARTING respond to the new market environment?**

We actively participate in the localization program. Consequently, we create new jobs, pay more taxes into the local budgets and transfer the latest technologies and competences into Russia. We opened a new production site at Yekaterinburg on March 25, 2015. Localizing is in general part of our international market strategy. Overall, we rate the current situation of our business as positive and will further pursue our localization strategy.



**Larisa Marnacheva**

is the Managing Director of ZAO “HARTING”, the Russian subsidiary of the German manufacturer of electrical and electronic connectors, device connection technology and pre-assembled cable and network components.

## „TECHNOLOGY TRANSFER AGAINST MARKET SHARES“

### **What measures does the import substitution policy of the Russian government cover?**

In the abstract, the import substitution policy shall diversify the Russian economy. But until now not all necessary implementing regulations and game rules are transparent and available to the public. This causes incidentally irritations among German exporters and investors.

For example, there are 18 decrees of the Minister of Industry and Trade. Each decree deals separately with a specific sector, where import dependency shall decrease largely to very largely by 2020. For each sector and product group the decrees define the level of the percentage market share for domestic producers in five years – which definitely reminds of the planned economy approach.

The only thing that is clear is that the imports in the named product groups are reduced. It remains unclear, how domestic producers should strengthen their positions, where the new products in the numerous industries do come from, and especially how these products shall be converted to serial production. And this in times, when the state due to falling sales is increasingly less able to pay out subsidies and investment grants. Bank loans are scarce and expensive, too.

During public procurement activities, imports are prohibited if there are at least two suppliers in the territory of the Russian Federation and/or other member states of the Eurasian Economic Union. If products or services are not available within the Eurasian Economic Union, in the second step suppliers from countries are preferred, who did not join the western sanctions. That applies in particular to Asia and Latin America. Only if this is again impossible, western producers may get a chance.

Western suppliers, and German among them, are expected to become “motivated” by these access restrictions to establish local manufacturing facilities. The idea is that in this case they could count as domestic producers.

But the process of earning the “Made in Russia” stamp is not finally defined yet. There still exist examples of European companies, who invested two- or three-figure sums of millions in brand-new productions, but still do not count as domestic producers. The government explains those cases with an insufficiently high local share of the value added – the “localization level”, as they call it in Russia.

In order to increase the localization level, a powerful local supplier industry is needed. But that one is de facto absent. Even Russian companies are forced to import components and supply parts from abroad, if they want to produce globally marketable final products. But there are no access restrictions at the state tenders for them. This unequal treatment of domestic and foreign investors in tenders or in government marketing assistance causes irritations, as already mentioned above.

### **Is the import substitution just a reaction to the sanctions of the “West”?**

The term “import substitution” has actually existed for decades, not only since 2014. The fact that in the Russian foreign trade energy resources and raw materials are traditionally exported, and industrial and agricultural products are imported, was and is a perennial issue of economic policy debates. But that did not lead to a course correction before 2014.



**Ullrich Umann**

is a business correspondent for Germany Trade and Invest (GTAI) in Moscow. The economic development agency supplies German companies with information on foreign markets and promotes Germany as an investment location abroad.

After the current sanctions appeared, the Russian government faced some factual constraints which it can no longer evade. That's because according to the provisions of the western sanctions high-quality technological industrial goods cannot be imported anymore. And, on the other hand, also because Russian industrial customers after two strong rounds of ruble devaluation and the predominant credit shortage do not have the financial capacity needed for the imports.

For a certain period, the Russian industry can still work flat out. The government wants to use this time frame to initiate domestic production of formerly imported industrial goods. At that the officials do quite bet on technology transfer from abroad. On the one hand, the investment conditions in the country have been tangibly improved, – completely developed land plots, tax remissions and state subsidies are offered almost by default.

On the other hand, foreign companies may participate in tenders only if they produce their goods in Russia. Minister of Industry and Trade Mr. Manturow describes this carrot and stick policy with the formula: "Technology transfer against market shares".

### **What results has the import substitution policy brought to this day? How far can it be deemed as successful?**

The import substitution policy leads in some sectors obviously to a suppression of the international competition. In my opinion, it would be more economically efficient, if the state would not force local settlement of foreign investors, but the companies would come into the country completely on their own free will. For instance, if local production would be profitable, because the factor of labour or other production expenses turn out favourable, or if short transportation routes to the Russian market help save additional costs.

The way the import substitution policy shows itself in its present form, it rather leads to a creeping decoupling of Russia from the international division of labour, and also to the development and conservation of monopolists in almost each sector, who win per se each public tender. Finally, the consumer will pay higher prices and receive only moderate quality, because the motivation for product development vanishes for these monopolists. In the long term, it will even hinder the modernization of the economy.

If the import substitution policy has caused something positive within the last two years, then in some extent in the machine tool industry and in the agricultural sector. However, the latter was successful because of a complete ban on imports of western food. As for machine tools, some first interesting prototypes were presented to the public. But serial production still falls short. The whole thing is still in the preliminary stage with an uncertain outcome.

The ruble – strongly devalued in the last two years – has triggered an entirely new development. The production costs based on US dollars or euros decreased in Russia as compared to other countries. In the meantime, a seamstress is cheaper here than in the PR China. Domestic and international textile companies even start transferring their production sites to Russia. Russian textile products can compete with imported products on the domestic market more effectively due to prices.

A similar development happens in other sectors, as in the petrochemistry and in the plastic production. But these developments are just indirectly related to the import

substitution policy. The initial point was rather the fallen oil prices, which caused and eventually accelerated the collapse of the ruble.

**In the course of the political tensions, the Russian government has been looking for the economic proximity to the PR China since 2014. Which tangible results were reached by this orientation and how far the hopes of Russia were realized?**

The hopes of the Russian government of a helpfulness of whatsoever nature or of an increased willingness of the Chinese policy and economy to cooperate have basically not been fulfilled. Though, much talked-about large-scale projects have been announced with great pomp. But they have been barely realized.

Indeed, there are some Chinese investment projects running. But they do not really have a lot to do with the reorientation to Asia announced in Russia. The major part of these projects has been agreed on and initiated long before the western sanctions. Some Chinese activities run, for example, in the construction materials industry, and specifically in the cement production. In the Far East Chinese companies are involved in the forest industry, including woodcutting for a further transportation of lumber to furniture factories in China.

Gazprom builds the natural gas pipeline "Sila Sibirii" to the PR China as planned. But it became surprisingly quiet about the second pipeline, that was meant to deliver natural gas over the Altai region to western China. It remains to be seen whether the announced Chinese automotive factories will really be created, or if cars will be further delivered from the PR China in view of the actually very weak automotive market trends in Russia.

The biggest disappointments seem to be appeared for Gazprom and Rosneft due to the toughest price negotiations with the Chinese. At that, the multi-billion investments in new pipelines are threatening to become unprofitable. And credit loans do not flow from China in the extent hoped for, too. It has become evident that the Chinese bankers are essentially holding on to the US-sanctions at the financial market against Russia – because for the financial world in Shanghai and Hong-Kong their current US-business seems to be more important than fresh credit loans for Russia.

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