

NEWSLETTER

INTERNATIONAL

 ENGLISH VERSION

RUSSIA



**RUSSIAN IMPORT SUBSTITUTION:
IMPACTS AND OPTIONS FOR ACTION**



P. 2

OVERVIEW:

Christian Tegethoff
IMPORT SUBSTITUTION
DEMANDS NEW BUSINESS-
MODELS ▶



P. 5

Andreas Schwabe
"SOME INDUSTRIES OBVIOUSLY
BENEFIT FROM SANCTIONS" ▶



P. 4

INTERVIEW:

Dr. Frank Schauff
"COOPERATION WITH
EUROPEANS WOULD BE MORE
BENEFICIAL FOR THE RUSSIAN
ECONOMY" ▶



P. 7

Dr. Dietrich Möller
"MANUFACTURE LOCALIZATION
MEANS A PRIORITY TO US" ▶

IMPORT SUBSTITUTION DEMANDS NEW BUSINESS-MODELS

In these latter months and weeks Russian politicians speak much about import substitution – it will evidently affect the business of international companies in Russia. Many companies explain sales dip in Russia by the fact that due to import substitution local manufacturers and suppliers from third countries are more preferable.

While import substitution in the public sector is considered as directive, in private sector this principle is used only in those fields where public funds are involved. Since summer 2014 the Ministry for Industry and Trade being responsible for industrial policy tried to reduce the import ratio in government orders.

The Plan of import substitution events dated March 31, 2015 is aimed at manufacturing of necessary industrial goods inside the country. This should replace the import goods from Ukraine and other countries which imposed sanctions on Russia with native-produced goods.

The Plan of import substitution events concerns 18 fields of industry

The Ministry for Trade and Industry's plans stipulate independent manufacturing of 800 types of goods in Russia. Within the program framework 2,059 projects in 18 fields of industry are to be implemented by 2020. For this purpose the "State Commission for Support of Import Substitution in Russian Industry" was established.

The import substitution plans are approved for the following fields of industry:

- Machine tool industry
- Automotive industry
- Heavy engineering manufacture
- Vehicles for agriculture and forestry management
- Oil and gas equipment
- Construction machinery
- Energy equipment
- Power networks equipment
- Public services equipment
- Special transport for airports
- Chemical industry, chemical equipment
- Wood processing equipment
- Air and space industry, including spare parts
- Shipbuilding industry, including spare parts
- Radioelectronics
- Equipment for food and beverage industry
- Pharmaceuticals (medicines) and medical equipment
- Consumer goods industry (separate fields)
- Metallurgy



Christian Tegethoff

Managing Director
of CT Executive Search

According to the Russian government, the total expenses on import substitution amounts to 1,5 trillion rubles (24,15 bln euro, 1 euro = 62,1 rubles at the exchange rate as of 16.06.2015). The government is ready to provide 235 bln rubles from the state budget. But the most part of expenses shall be borne by the enterprises using their own funds or involving credits.

The most attention in the plans is paid to the machine-building industry. Machinery in relation to which Russia highly depends on import must roll off the production line not later 2020. This primarily concerns machine tools used in defense industry: at the moment Russia buys almost all machine tools spare parts abroad.

The Russian government's policy aimed at import substitution can increase for a short time demand for high-quality machine tools and spare parts because they are necessary for creation of additional production capacities in durable equipment.

But import should be substituted only in the sectors which have especially strong dependence on it. Thus, Russia procures itself with stainless steel of own manufacture by 67% today. This ratio must increase to 82%. In this regard it is necessary to upgrade and enhance production capacities of steel plants which require investment. Even more ambitious goals are set for reduction gear producers – and these goals can also be reached only by means of new plants construction.

At the moment the main question is whether European or American suppliers could benefit from modification demand and enhancing production capacities. The import substitution campaign is accompanied by media covered policy of external-economic reorientation of Russia at the countries suppliers which did not join EU and US sanctions. Here some countries go to the foreground such as Switzerland, China, South Korea and Taiwan. For instance, in EU only procurement of capital goods with characteristics of unique selling point is allowed.

How the companies can react?

The companies who intend to open manufacture in Russia are welcome. Technologic transfer is encouraged in order to reduce import dependence. Russian companies with foreign investment are considered as national companies and thus are not subject to import substitution measures and can benefit as local manufacturers.

Alternatively, the Russian market can receive supplies from the countries which did not impose sanctions on Russia. In this regard European countries can supply their goods produced in China to Russia with no trouble.

Therefore, regardless of all problems, import substitution measures do not mean the Russian market will be closed for American and European companies. But it will be required to update supply chain and verify how reasonable manufacture localization in Russia would be from the economy point of view. By making this step some companies could essentially increase their market share due to competition decrease. In some fields, it could be reasonable to conclude license agreement with a Russian manufacturer in order to localize manufacture with less financial expenses. ►

Anyway, it is advisable not to dismiss the Russian market but to be realistic about business chances in new environment. In spite of all risks, new framework conditions give a great chance.

This article was prepared on the basis of materials of Germany Trade and Invest Agency (GTAI, www.gtai.de).

INTERVIEW

“COOPERATION WITH EUROPEANS WOULD BE MORE BENEFICIAL FOR THE RUSSIAN ECONOMY”

What are the consequences of import substitution policies for international companies operating in Russia?

Firstly, I would like to note that these policies are the Russian government's reaction to measures implemented by the West – they are aimed at decreasing Russia's dependency on the West and supporting the economy. The Russian government intends to stimulate economic modernization under these new conditions. Currently, the government is favoring protectionist measures that are aimed at eliminating the participation of or competition from foreign companies. We are holding talks with the authorities in order to ensure that companies working toward localizing production in Russia have a level playing field.

Naturally, foreign companies are reconsidering whether or not they want to enter the Russian market at all. Of course, it only makes sense to do so if there are economic opportunities here.

The government has placed a lot of hope in import substitution. But is there enough opportunity? Does the country have sufficient financing capabilities and a competent workforce? We are starting to wonder if economic development is possible without European companies, and we do not think that it is likely.

Is import substitution a long-term policy or a temporary measure?

The pendulum has swung in the direction of import substitution. Everybody understands that the European sanctions may be in place for a long time – until there are some political changes the EU is hoping to see. However, there are still opportunities in spite of the sanctions, since these policies affect only a small number of companies and work can continue in other areas. If demand in Russia increases again, business will come back to life. The sanctions may be lifted at some point, which would moderate the enthusiasm for import substitution policies.

Does localizing production make sense for international companies? Should we expect localization to become a trend?

As the key representative of European business in Russia, we see both the strengths and the weaknesses of the Russian economy. ►



Dr. Frank Schauff

is the CEO of the Association of European Businesses (AEB) representing the interests of the European economy in the Russian Federation. He is a member of the Advisory Board at CT Executive Search.

In the long-term, Russia will remain an important market that our companies will have to participate in. Because of this, we recommend that companies think about entering the market while taking all risks into account. Right now this is relatively cheap to do due to the weakening ruble, lower process for real estate and relatively low actual wages.

How have import substitution policies influenced the Russian economy?

The aim of these policies is economic growth, but the big problem is the fact that investment activity in Russia is relatively low. Because of the sanctions, financing is difficult and the cost of attracting capital is high. In my opinion, there is a growth trend, but, contrary to some expectations, we will not see any big jumps. We think that cooperation with Europeans would be more beneficial for the Russian economy. A lot of mechanisms can be purchased from China, but the question is whether or not this would be a sound option in terms of production economics.

How will this affect consumers?

What does import substitution mean in terms of quality and price? The Soviet Union was a large-scale import substitution experiment that ended up failing. Thus, it needs to be well-organized in order to avoid falling behind.

The embargo on food products has not led to dramatic consequences such as deficits or shortages, but the quality in some segments has decreased. There is a shortage in supplies of dairy and meat products, the prices for which have increased dramatically.

The interview with Frank Schauff took place in June 2015.

“SOME INDUSTRIES OBVIOUSLY BENEFIT FROM SANCTIONS”

To what extent the plans for import substitution with domestic products are economically viable?

Generally speaking, countries that imported goods and modernized their economy were successful rather than those that used import substitution supported by the state. There are some examples in Asia. Currently, Russia tries to compensate the deficiencies caused by refusal of imported goods by the advantages for the local manufacture appealing to the new manufacturing sectors being developed. Food industry is a good example.

However, the assumed development of the new manufacturing sectors is disputed due to the following reason: if the conditions for investments in the country are so attractive why these investments have not taken place before? In this case, one may suppose that the problem lies in something different, e.g. political conditions. ►



Andreas Schwabe

is the Senior Financial Analyst for the Region of Central and Eastern Europe of Raiffeisen Bank International, Austria, Vienna. He specializes in the currency exchange rate analysis and national economies of the Region, paying special attention to Russia and Ukraine. In this interview he explains the Russian import substitution policy consequences for the country's economy.

All in all, isolation is good for manufacturers and may negatively affect consumers as it results in higher prices and lower quality. How strong are Russian consumers? Food sanctions were introduced during the political campaign and the population just came to terms with such a policy. However, manufacturers are discontent, e.g. oil and gas sector complains. The state constantly directs who imports, where and how much should be imported. It is tug-of-war.

Are there any industries that benefit from sanctions and import substitution?

Some industries obviously benefit from sanctions, e.g. the Russian food industry, although, for the last twelve months, it has grown by only by 3.2 percent which is not a huge leap.

However, in general, Russia is at the stage of recession, the volume of investments has decreased for the last two years, the recent drop in the retail turnover is double digit. Positive effect of import substitution is hardly noticeable. The industry might catch up thanks to isolation. However, several years have to pass to achieve positive results.

Simultaneously, there is a risk that only market participants who have good connections in Russia will get attractive orders. International competition would be much more beneficial for an obviously misgoverned economy.

Will this policy result in the deficit of goods that cannot be manufactured in Russia?

It depends on implementation of the import substitution measures. I believe that Russian legislators are flexible enough to avoid the deficit. Pharmaceutical industry is a good example: it is regulated; however, import of vital medications is not banned indiscriminately. There are global maneuver opportunities for food products, and ultimately, it's all about redirection of commodity flows. This results in forced procurement under unfavorable conditions and substitution with local goods that can be more expensive and of lower quality.

Will this policy result in growth of direct foreign investments in Russia?

Economically, foreign companies will have an opportunity to enter the local market. However, currently, the political component is very strong, and the companies are likely to be cautious at least in the West. This is not supported by any data but a breakthrough is very unlikely, in fact. However, a company working in the market for a long time and being familiar with framework conditions at least as any Russian company may benefit.

To what extent Russian companies are technologically capable of filling in the gaps resulting from the refusal of import?

I am not an expert in technologies of individual branches of economy but Russian companies themselves have many doubts that these gaps can be filled-in quickly. The assessment depends on a timeframe, however, global companies have much more advantages and it will be quite difficult for local companies to catch up with them. The assumption that everyone can do everything is contrary to the specialization provided by the economic theory. Isolation may result in stagnation.

"MANUFACTURE LOCALIZATION MEANS A PRIORITY TO US"

How the import substitution measures would impact on Siemens' business in Russia? How does Siemens react at Russia's import substitution measures?

Our company has been working in Russia for already 162 years. Just after enter into the Russian market in 1853 Siemens became an international group. Russia is a very important country for our business. Here we implement projects almost in all sectors of economy: from energy to railway industries.

Today Siemens is not only a representative of a large group in Russia but also a full-scale Russian company with its own plants, manufactures, as well as design and experimental and service centers.

We are currently working on dozens of projects around the country. In this context manufacture localization means a priority to us. Ten manufacture plants have been opened in the Russian regions.

On June 18, 2015 we are opening a new plant in the Leningrad Region – LLC "Siemens Gas Turbine Technologies". This plant will produce high-quality E-class and F-class gas turbines with capacity of more than 60 MW and will represent the Russian center of Siemens for producing equipment for gas turbines and compressors. It is important that we intend to gradually increase both share of Russian spare parts and volume of our own manufacture.

Another plant that we built from scratch has been already put into operation in Voronezh. I mean LLC "Siemens Transformers". The plant produces power transformers for the Russian market and abroad.

Railway transport projects are especially important for us. Many know our passenger trains "Sapsan", "Lastochka" and electric freight locomotive "Granit". In order to produce short-range electric trains "Lastochka" and electric locomotive "Granit" we built near Yekaterinburg a special plant "Ural Locomotives" together with our JV partner, Sinara Group.

According to the agreement 1,200 "Lastochka" carriages will be produced in the coming years with an inscription "Made in Russia". This is of great importance not only for Siemens but also for local suppliers because in such a way we develop the network of Russian suppliers. At the moment about 100 Russian companies supply spare parts for electric trains and by 2017 the level of localization of "Lastochka" trains produced at "Ural Locomotives" will reach 80%.

Will Siemens now involve direct investment which would not be involved if the import substitution supporting measures were not taken?

Several years ago we announced establishment of our own investment program according to which Siemens together with its partners were going to invest in Russian projects about 1 bln euros. Today we are at the last stage of its implementation. ►



Dr. Dietrich Möller

President of Siemens in Russia and Central Asia

Our main investment was made into the railway machinery cluster in Yekaterinburg where more than 1,300 work places were created. Another principal direction is our plant "Siemens Gas Turbine Technologies" in Gorelovo, a village near Saint-Petersburg, which is to be officially opened in June 18, 2015.

About 500 specialists will work at the new plant. Another strategically important manufacture is located in Voronezh. LLC "Siemens High-Voltage Machines" and LLC "Siemens Transformers" are operating there. Meanwhile, LLC "Siemens Electric Motor Drive" produces electric motors and converters in Saint-Petersburg.

I would also like to notice that the investment program consist not only of figures and investment scope ratios. First of all it means new work places in the regions, new technologies and solutions which Siemens uses at its manufactures.
