

RUSSIAN FEDERATION

Overview

The Russian defense industry is in the midst of several changes. These adjustments include a shift from production of military to commercial goods; the planned privatization of up to three-fourths of the industry; the restructuring of very large firms into an emerging mixture of holding companies, joint ventures, and small spin-offs; and a shift from isolation to full participation in the world economy. These changes are creating economic challenges for the firms and distress for many Russian cities and regions. At the same time, these changes may offer opportunities for American business.

Defense Industry Environment/Defense Conversion

The Russian defense industry is in a state of decline and disarray. Traditional sources of support -- the defense budget and orders from Soviet satellites -- have dwindled over the past 10 years, and new sources of income have not yet emerged. Most defense plants reside in very old buildings and rely on old equipment. Defense industry pay has not begun to match inflation, and many defense engineers and production workers are leaving defense firms to start small technology firms, operate kiosks, or drive taxis.

Historically, Russia spent over 20 percent of its gross domestic product on defense. In recent years, this figure has hovered around 5 percent of a smaller domestic product. The Russian Duma appears to have settled on a defense budget of about 40 trillion rubles (\$20 billion). The proposed budget also includes 18 trillion rubles (\$9 billion) for industrial support, much of which will go for defense conversion.

Russian defense figures are easily misinterpreted. Much defense budget money actually goes for civilian production and social services for defense workers. Most defense plants and defense bases receive hidden subsidies from regional and city governments in the form of free land, electricity, food supplies, and other services.

The Russian defense industry consists of over 2,000 firms and employs 6 to 8 million workers, about one quarter of the Russian industrial labor force. The Russian defense industry is concentrated in twelve cities and regions, where over one-third of the labor force works in defense. The industry needs modernization and many defense enterprise managers are eager to learn about the basics of marketing, finance, and modern business practices.

A Russian defense plant is also, in some ways, a throw-back to a U.S. factory town. The defense plant is really a mini-city in itself, with its own apartments, doctors, clinics, restaurants, and power plants. Outside of Moscow and St. Petersburg, defense plant employees usually live in company apartments, shop in company stores, and eat in company cafeterias. Up to 80% of a defense plant's budget goes to maintenance of these social services. The plant manager is often as

concerned with making deals to bring in potatoes and bread to feed his people as with joint venture agreements.

Most Russian defense enterprises would be considered bankrupt in Western terms. Russian defense plants have lost nearly 80% of their funding from the Russian government in the past ten years. Defense orders dropped markedly and production dove by 50 percent, just in the last two years. At the same time, defense plants have lost export earnings due to loss of Soviet bloc markets, cuts in Russian aid to Libya and Iraq, and declined in size of the world arms market. Arms exports have dropped by over 70 percent since 1990.

Plant managers often maintained production without budget authority to keep workers busy. This has led to an excess inventory of weapons, which plant managers try to sell. Uncertainty in the Russian budget has prevented most Russian defense enterprises from consistently paying their workers or their debts. Some are months late in paying salaries. Many defense plants reduced operations to only a few days per week. Russian defense industry wage increases have not kept pace with inflation, meaning that most Russian defense enterprises are steadily losing their best workers (estimates range from 800,000 to 1 million lost per year) to Western companies or the emerging Russian private sector.

The Russian Government strategy has been to target Western assistance and limited budget funds to a small number of key, technology-rich research and design institutes. Prime Minister Chernomyrdin has indicated that he will now permit unprofitable firms to go bankrupt, though last minute bailouts will probably still occur.

Social and economic change has brought with it changes in the structure of the defense industry. Under the old Soviet system, the defense industry consisted of three tiers. At the top were the elite research institutes; the next tier included the design bureaus; the third and the largest were the manufacturing enterprises. One hundred final assembly plants (80 with over 10,000 workers, 20 with over 25,000 workers) were the largest in the sector. To cope with new economic conditions, many newly-privatized Russian defense enterprises are joining forces in industry groups or holding companies. Examples include the Leninet Holding Company in St. Petersburg, the Arsenal Holding Company in Tula, and the Tupolev Joint-Stock Company in Moscow. Many defense engineers have left defense firms to found their own companies or have started mini-enterprises within the confines of the old firm.

Nearly all Russian defense equipment is produced by domestic firms. In the recent past, Russia was a part of the Soviet bloc military-industrial complex, with interrelated units throughout Eastern Europe and the former Soviet Union. Today, most supplies and equipment are produced within Russia, with limited purchases from other NIS and Eastern European nations. Historically, Russian defense firms have always sought and managed to acquire Western military and dual-use technology. This interest can be expected to continue, with limited commercial purchases sometimes substituting for espionage. The Department of Commerce, through the Bureau of Export Administration has published several editions of the Russian Defense Business Directory, which provide more detailed information on the major Russian defense firms.

Pure defense opportunities in Russia for U.S. firms are very limited. The Russian government intends to use limited defense funds to maintain Russian defense capabilities and is unlikely to invest in weapons systems from the West. Some opportunities exist through U.S. Government aid programs that help the Russian military dispose of weapons.

A large market for U.S. defense firms involves assisting the Russian military and government to safely dispose of nuclear, chemical, and biological weapons and prevent proliferation of Russian weapon technology. There is some U.S. Government money available to help in this effort. Specific activities include:

- Destruction of nuclear weapons
- Improvements in nuclear weapon security and accountability systems
- Safeguards against weapons proliferation

Another potential service is education and training. Russian industrial managers and military leaders are anxious to learn about the management and manufacturing methods of the West.

Many of the Russian Ministry of Defense's major new initiatives are commercial, not military. Major projects within the Russian defense sector are listed below.

- Next generation commercial airliners: Ilyushin and Tupolev are developing a new generation of commercial airliners for NIS and global markets.
- Merchant Marine: Russian shipyards are re-equipping the Russian oil tanker and cargo vessel fleet.
- Telecommunications 50 by 50 project: Russian defense firms are building equipment for a major upgrade of Russian telecommunications system.
- Global Navigation System: Russian defense firms are working on a global satellite system to improve aircraft navigation across Asia.
- The U.S.-Russia space station: Russian defense firms are preparing to work with American partners on a joint space station.

Russia has defined a new role for itself as a peacekeeper in Russia's near abroad or neighboring republics of the former Soviet Union. The Russian military is attempting to regain military potency with dwindling financial resources. With this change, the Russian military is shifting strategies and doctrine. First, the military is deferring new production to focus on systems upgrades and research. Second, the military is shifting from military-only research to dual-use technology research that will benefit the Russian economy. Third, the Ministry of Defense is seeking to initiate the creation of about 30 defense-industrial-financial conglomerates that would produce both military and civilian high technology equipment. Finally, the military is moving beyond its prior emphasis on weapons procurement to focus on improvements in

weapons maintenance, information processing and battle management.

The Russian Defense Ministry has procurement procedures similar to the United States. Information about procurements is becoming more readily available. With many Russian defense factories idle, the Russian Ministry of Defense is unlikely to give major defense contracts to non-Russian firms.

Diversification/Commercial Opportunities

Despite a challenging economic and political environment, the Russian market offers a variety of trade opportunities for U.S. firms.

Telecommunications Equipment

The Russian telecommunications market suffers from a lack of installed lines, outmoded switching equipment, and inadequate revenues to finance investment. Over \$1 billion of telecommunications equipment was sold to Russia in 1995, but only ten percent was of U.S. origin. The Ministry of Communications is dedicated to bringing the telecommunications infrastructure up to international norms as quickly as possible and many multinational firms are looking for the opportunity to help in this undertaking. Undoubtedly, very large investments will be made, with much of the capital and equipment provided by foreign firms. Demand, political will, and interest from foreign investors have coalesced around telecommunications, virtually ensuring that significant agreements will be reached over the next eighteen months.

Medical Equipment

Because domestic medical equipment production can meet only 40% of total demand, imports play a significant role in the market. Government purchases of foreign medical equipment are usually financed by foreign loans, foreign credit lines, and internationally-sponsored development projects. The Ministry of Health and Medical Industry no longer makes centralized purchases. Instead, regional health authorities, or hospitals whose funding is at least partially provided by local companies, are the principal buyers. In some cases, large manufacturing enterprises have become active purchasers for their own hospitals, clinics, and medical units. The most promising subsectors are radiology, diagnostic equipment, laboratory equipment, dental equipment, and test kits.

Privatization

The Russian Government plans to privatize three-fourths of its more than 2000 defense enterprises by the end of 1994. About 700 of Russia's defense enterprises have already been privatized. About 450, mainly research institutes and design bureaus, will remain government-owned. Many talented Russian scientists and engineers are setting up spin-off companies to market commercial applications of defense and other technologies. To survive as privatized firms, most Russian defense enterprises will need Western management help, investment, and cooperation. With encouragement from the U.S. and Russian governments, many Russian

defense enterprises are seeking Western investors and partners.

Some U.S. Government funding is available to support joint ventures between U.S. and Russian partners and information on these funds will be included in the section on points of contact.

Market Prospects

The Russian economy is plagued by decaying infrastructure, severe environmental problems, insufficient housing, and shoddy consumer goods. To address these tremendous challenges, the Russian government has been trying to convert defense plants to produce civilian products. During the Gorbachev era, specific defense sectors were directed to focus on specific commercial sectors. For example, biological weapons plants were told to focus on medicines. The Yeltsin Government approach is to use Government credits to encourage defense plants to shift toward priority sectors.

Russian defense firms, while stronger in engineering and manufacturing, often lack expertise in marketing, management, and financial analysis and control. Most lack understanding of how to set prices and determine the unit costs of products. Many require help in designing and marketing products to respond to the demands of Russian and other consumers. U.S. firms could work with spin-offs of Russian defense firms to jointly produce goods for Russian and NIS markets. Although short-term barriers to such cooperation are numerous, some long-term potential for such joint ventures may exist for several reasons.

- *Low manufacturing costs:* Russian defense enterprises operate at costs considerably lower than Western ones. Russian defense enterprises often pay their engineers \$100 or less each month. While these enterprise may not technically own their own property, they may assert some management control over it. These facilities often include power supplies, transport systems, hotels and apartments, and water supplies.
- *Pockets of superior technology and expertise:* To a visiting Westerner, Russian defense plants usually appear to be poorly maintained and hopelessly outmoded. Russian technological and industrial development took place in isolation from the West, along parallel though dissimilar lines. As a result, in most technological areas, particularly electronics and computers, Russian scientists are well behind their Western counterparts. At the same time, operating independently, Russian scientists and engineers developed unique approaches and capabilities still unknown to the West. Russian technological strengths identified by an interagency technology assessment group in 1990 include:

- Chemical/allied products
- Rubber and plastic products
- Primary metals
- Small nuclear power reactors
- Industrial/commercial machinery
- Electronic components

Transportation equipment
Photographic, medical, and optical instruments
Space launch and payload services
Metallurgy
Aerospace
Lasers and optics
Software Design

- *Market Access:* Working with a Russian defense firm is one way U.S. firms can attempt to gain a toe-hold in Russian and NIS markets. Defense firms are becoming more adept at marketing and they have access to vast networks of suppliers and sub-contractors within the Russian defense establishment. Many also have political connections and clout that can help to reduce barriers to trade and eliminate government obstruction.

On paper, the Russian Government has developed a defense conversion plan and selected 14 areas for conversion efforts. Thus far, the government has allocated a mere \$3 billion to stimulate this conversion process. In these areas, Russian defense firms will need Western products and technology to succeed in conversion efforts.

- **Civil Aviation:** Russian manufacturers need Western engines and avionics to bring the Russian civil fleet up to world standards.
- **Civil Shipbuilding:** Russian shipyards need to build oil tankers, fishing trawlers, cargo ships, and pleasure craft.
- **Oil and gas industry equipment:** Russian missile equipment and tank plants are now building oil drilling pumps, excavation equipment, air compressors, and gas liquefiers.
- **Housing:** The Russian defense sector may begin to address Russia's severe housing shortages. Defense firms attempting this will need help producing homes, apartment buildings, internal equipment, and appliances.
- **Consumer Goods:** The Russian defense sector produces nearly all of Russia's televisions, video cassette recorders, and cameras, plus most washing machines and vacuum cleaners.
- **Medicine and Medical Equipment:** Defense plants produce 80 percent of medical equipment produced in Russia. Biological weapon plants are now converting to vaccine and medicine production.

Other high priority industry sectors include the following.

Food Processing
Textile Industry Equipment

Communications and Information Equipment
Timber Industry Equipment
Electronics
Pollution Control Equipment

US&FCS Moscow recommends that prospective exporters contact a relevant foreign trade association. A preliminary list is provided below.

- Aviaexport
Trubnikovskiy Per. 19, 121817, Moscow
Phone 290-0171, Fax 290-0171
Export and Import for Aircraft, Aircraft parts, and Avionics.
- Litsenzintorg
Minskaya Str., 11, 121108 Moscow
Phone 145-2700, Fax 142-5902
Technology Exchange and Transfer.
- Mashinoexport
Smolenskaya-Sennaya, 32/34, 121200 Moscow
Phone 244-3309, Fax 244-3807
Import of Oil and Gas Extraction and Refining Equipment.
- Mashinoimport
Mosfilmovskaya Str., 35, 117330 Moscow
Phone 147-1542
Export and Import of Machinery for Machine Building, Mining, Transport, Agriculture, and Shipbuilding

Doing Business in Russia

Doing business in Russia is not for the timid. Russia is a vast, largely unpenetrated, market. Opportunities abound, and so do barriers. For more than four decades after World War II, Russia was the central part of one of the world's two superpowers. Russia owed this status to its highly skilled population, its abundant natural resources, and the concentration of its resources on defense. For more than 70 years (some would say for centuries), Russia cut itself off from Western goods, Western ideas, and Western technology. With Gorbachev's Glasnost and Yeltsin's Perestroika, Russia has begun to open its markets to the West. The result is an unprecedented hunger for Western (and particularly American) products, technologies, and ideas. Though this demand continues unabated, the more than 400 U.S. companies entering this market have encountered difficulties.

A major cultural barrier is the Russian's lack of experience with a market economy. While informal "Rynoks" and black markets existed under the communists, most Russians do not understand the fundamental operations of a modern capitalist system. Western businesses will

need to dedicate much time to explaining business planning, modern accounting, marketing, and contract law. U.S. business is rooted in the sanctity of contracts and legally based and enforced agreements. Russian business is based on personal relationships and a sense of the relative power and influence of potential business partners.

The major economic barriers are the many taxes and fees imposed by different levels of the Russian Government. These taxes are often contradictory and arbitrarily applied. While Western firms can avoid many of these taxes by following sound legal and accounting advice, constant tariff and tax changes and the inability to get information on the latest laws makes long-term profit projection difficult at best.

The major political barrier is the lack of consensus within the Russian Government that the movement toward capitalism and the attraction of Western investment is the correct course. While the Yeltsin-Chernomyrdin government is generally pro-reform, many political and bureaucratic leaders are reluctant to assist in what they perceive to be the selling off of their country to the West. Many promising Western investments are sidetracked by long delays in government approval and sudden changes in regulations. Russian contract, property, and intellectual property protection laws are still undeveloped and enforcement of existing laws is uneven.

In addition to these barriers, Western businesses also face a growing crime problem, a chronic scarcity of reliable information, and frustrating and formidable logistical problems. These barriers (and a fear of the unknown) have kept many Western businesses out of Russia. The result is that those businesses that have learned to operate successfully in Russia are beginning to sell to a large and expanding market with comparatively little competition.

Listed below are suggested business strategies:

- Find a formal or informal Russian partner.
- Maintain good contacts with other Western businesses as well as national and regional government officials.
- Hire a good accounting and law firm to remain several steps ahead of constantly changing taxes and regulations.
- Develop a long-term strategy that gradually builds relationships and market presence.
- Make an investment in security protection for facilities and employees.

In the defense sector, a few Western firms have formed joint ventures with Russian defense firms or worked with spin-offs from Russian defense firms. The extensive social services provided by Russian defense firms and the large numbers of workers in unprofitable activities make nearly all old-style Russian defense firms very poor investment opportunities, however, even when fully privatized.

Other potential business strategies include:

- Selling U.S. components for use in Russian products
- Using Russian defense plants for final assembly of U.S. products
- Jointly redesigning U.S. products for Russian production for Russian and NIS markets
- Selling technical expertise to help Russian defense firms redesign their products for Russian and NIS markets

A few U.S. firms purchase Russian technology directly or provide research contracts to convert Russian defense technology for use in U.S. products.

U.S. defense firms, in particular, should be wary of Russian buyers seeking critical defense and other technology. Such buyers may request detailed product specifications, technical data, and/or the purchase or loan of single examples of high-technology products or components. Intellectual property law in Russia is not as well-respected or enforced as in the West. U.S. firms run the risk that Russian buyers will use U.S. technology to develop competing products, or may privately sell the U.S. technology to third parties.

Trade Barriers and Export Controls

Taxes: Russian taxes are usually high and fines for tax evasion can be steep.

- ▶ Russian tariffs average about 10 percent. However, tariffs on automobiles, alcohol, and tobacco products range from 35 to 150 percent.
- ▶ A value-added tax (VAT) is set at a standard rate of 23 percent. Presidential Decree 2270 of December 1993 eliminates the VAT on items imported into Russia that are part of the seed capital of new Russian enterprises.
- ▶ Excise taxes between 35 and 250 percent are applied to luxury goods, such as cars, jewelry, alcohol, and cigarettes.
- ▶ An export tax of about 20 percent is now levied on most exports.
- ▶ An enterprise profit tax ranges between 32 and 38 percent. Tax holidays and preferential rates exist for small or new businesses growing crops, making consumer goods, or constructing buildings.
- ▶ An individual income tax on worldwide income is set at 40 percent.
- ▶ Property tax may be up to 2 percent per year.

- ▶ Companies will need export licenses to export many raw materials.
- ▶ Foreign operations should be either registered or accredited in Russia. An accredited company can do business and sign contracts, but cannot engage in financial transactions. A registered company can engage in transactions.
- ▶ Companies with charter capital over 100 million rubles should also register with the Russian agency for international cooperation and development.
- ▶ Foreign firms located in Moscow need to obtain licenses from the city government.

Export controls

In the defense sector, U.S. companies must consider both Russian and U.S. regulations. The Russian export control decree provides for export control oversight over materials, equipment, and technology used to produce weapons, and civilian dual use materials and technologies that can contribute to missiles, nuclear, chemical, and other weapons of mass destruction.

The Department of State maintains a U.S. munitions list that identifies defense articles and services. U.S. firms participating in defense trade must register with the State Department's Office of Defense Trade Controls and seek approval for the export of any items on the munitions list. The Commerce Department's Bureau of Export Administration administers export controls on dual-use technologies. U.S. exporters are now permitted to ship some low-level dual use goods to civilian end users in Russia, under a license exception, without prior approval.

Other goods and technical data still require a specific license, or are not eligible for export. These are controlled due to their potential use in nuclear, biological, chemical, and other weapons. Controlled items include chemical weapons precursors, super computers, high-end computers capable of over 7 billion theoretical operations per second, and electronic equipment with potential military applications. U.S. exporters may not knowingly ship dual use goods to military end-users. U.S. companies should consult the Bureau of Export Administration before engaging in consultations or business transactions involving the export of controlled commodities or technical data.

U.S. Government Points of Contact

The following is a list of useful contacts for firms interested in the Russian market.

U.S. Embassy

U.S. & Foreign Commercial Service
Ul. B Molchonovka 23/28
121019 Moscow

John Peters
Senior Commercial Officer
Tel: 7-095-967-3414
Fax: 7-095-967-3416
Sat. Tel: 7-502-224-1105
Sat. Fax: 7-502-224-1106

St. Petersburg

U.S. & Foreign Commercial Service
American Consulate General St. Petersburg
S7 Bolshaya Morskaya

Patricia Gonzalez
Acting Principal Commercial Officer
Tel.: 7-095-119-6045
Fax: 7-095-213-6962

Vladivostok

U.S. & Foreign Commercial Service
American Consulate General Vladivostok
Mordovtseva 123, Vladivostok

U.S. Mailing Address:
American Consulate General
U.S. Dept. Of State
Washington, D.C. 20521-5880
Rich Steffens
Principal Commercial Officer
Intl. Tel: 7-501-4232-300-070 (Satellite)
Intl. Fax: 7-501-4232-300-072

Business Information Service for the newly
Independent States (BISNIS)
Room 7413
U.S. Department of Commerce
14th and Constitution Ave., NW,
Washington, DC 20230
E-Mail: bisnis@usita.gov
Tel: 202-482-4655
Fax: 202-482-2293
Flashfax: 202-482-3145

Defense Conversion

Bureau of Export Administration
Office of Strategic Industries
and Economic Security
Room 3878
14th & Constitution Ave., NW
Washington, D.C. 20230

Tel: (202) 482-3984
Fax: (202) 482-5650

Special American Business
Internship Training Program
15 Novinskiy Bulvar, Dom 15
121099 Moscow
Tel: 202-482-0073
Fax: 202-482-2443

In Russia:

Tel: 011-7-095-255-4848
Fax: 011-7-095-230-2101

Potential Funding Sources

U.S. Russia Investment Fund
17 State Street, 33rd Floor
New York, NY 10004

Tel: (212) 668-8395
Fax: (212) 668-0770

The Defense Enterprise Fund
Tel: (617) 261-1924
Fax: (617) 261-1935

Industry Association Contacts

American Chamber of Commerce
American Trade Center, Radisson Hotel
Berezhkovskaya Nab. 2, Moscow
Tel: 011-7-095-941-8435
Fax: 011-7-095-941-8437

St. Petersburg American Business
Association
Susan Kersch
Tel: 011-7-812-275-4587

St. Petersburg Joint Ventures Association
Plehanova St, 36, St. Petersburg
Peter Lebedev
Director

Tel: 011-7-812-312-7954
Fax: 011-7-812-315-9470

U.S. Russia Business Council

1701 Pennsylvania Ave., NW
Suite 650
Washington, D.C. 20006